

Measuring Political Risk

A decorative horizontal band with a blue gradient and a white, lightning-like pattern.

Risks to Foreign Investment

Charlotte H. Brink

MEASURING POLITICAL RISK

*Dedicated to Sergio, André, Lottie, Lorna, Suzie, Di,
Hermann, and Karen
Thank you.*

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Preface

In light of operating in complex modern global business environments, the ability to analyze and subsequently manage political risk as risk to foreign investment is an essential tool for any decision maker to have access to. Making and implementing complicated choices regarding foreign investment that impact directly on the operationability and profitability of an organization, often takes place under circumstances of extreme uncertainty. The analysis and management of political risk aims to decrease such uncertainty, and to at least offer decision makers an idea of “what is out there”. Factors that may threaten the returns on an investment can be recognized; the probability and consequent intensity of the risk factors’ impact on an organization can be measured; and contingency plans for managing political risk can be formulated and budgeted for.

Foreign investment is by its very nature an activity that takes place in a country or countries other than that from which it originates. Host countries have differing political systems, economic prospects, qualities of human capital, business systems, political cultures and investment climates – yet these form the backdrop against which business is conducted every day.

This “how to” book on measuring political risk offers foreign investment decision makers a tool that can be used during viability assessment processes. The methodology offered includes important micro risk factors; is easy to use; is robust in the sense that including or omitting risk factors can take place to best suit the organization’s needs; the weights of the factors can be adjusted; the factor motivations are transparent; and the methodology is comprehensive. Short from avoiding threats despite good returns, it also offers risk averse investors a way to plan in the event of certain types and levels of risk occurring. By being able to recognize and quantify something as elusive yet threatening as political risk, investment and entrance strategy can be negotiated; the extent of the capital budget for the investment project can be calculated, as well as the clauses, add-ons, and cost of premiums that are to be included in a contract with a political risk insurance provider.

This model for the analysis of political risk can be useful for large corporate as well as smaller foreign investors, for governments and their investment agencies, for non-profit and aid organizations, private lenders and investment banks, for researchers, and for the future pursuit of further improving upon political risk analysis methodologies.

Charlotte Brink
Stellenbosch, March 2004

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Chapter 1

Introducing Political Risk

Introduction

Political risk and the analysis thereof remains a highly fascinating and extremely interesting phenomenon, and keeping up with the ever-expanding nature thereof is indeed a challenge.

This introductory chapter attempts to offer at least some clarity on questions relating to political risk analysis. One of these relates to developing the theoretical and practical ideas and motivations that prompted this book. Apart from placing the topic of the book in context, this chapter also aims to explain why the topic was decided upon, what the importance and uses of this book on political risk can be, as well as its relevance.

The term investment implies an expected return. This differentiates the action of making an investment from giving a gift. Yet a return on an investment is difficult to guarantee, if at all. This implies that an investor runs the risk of not receiving expected returns, making fewer gains on the investment, or losing the investment entirely. The cause of such losses is almost always beyond the control of those making decisions regarding investment. Although a more detailed conceptual clarification follows in the second chapter, for a foreign investor a working definition of political risk analysis broadly encompasses *the analysis of the probability that factors caused or influenced by the (in)action or reactions of stakeholders within a political system to events outside or within a country, will affect investment and business climates in such a way that investors will lose money or not make as much money as they expected when the initial decision to investment was made.*¹ These factors can be of internal (from inside the host country) or external origin, and can pose macro (generic) and/or micro (specific) risks.

Foreign investment projects are subject to the sovereignty of the host country in which they are active. Such projects can enjoy strong and enforceable protection mechanisms under laws regarding ownership, stable investment codes, tax incentives, guarantees against expropriation, and the guaranteed unrestricted remittance of profits. However, under the very same sovereignty, a foreign investment can be “taken hostage” or “held for ransom” by a looming threat of government renegeing on negotiated and seemingly secure contracts, concessions or licenses. The same laws that protect abiding foreign investors as guests in a host country can in fact constrain profitability and operationability.

Sovereign laws of a host country are either perceived as being on the side of foreign investors, or not. Strategizing around foreign expansion endeavours often deal with questions about whether positioning and roles within a host country can be negotiated; whether the presence of foreign investors are resented, barely tolerated, or hard-earned. The dependence of a host country on foreign investment can be a double-edged sword. Non-essential investments, for instance those outside the provision of public services, should be ready to manage their positions in a host country with great flexibility and adaptability without becoming so attractive as to warrant nationalization.

Such positioning is surpassing the goals of economic and financial gain, as organizations are increasingly confronted with political and social factors as well. A host government might welcome foreign investment – but do the governed? Triple bottom lining involves investment decision making based not only on financial responsibility, but also on socially and environmentally accountable business practice. Yet political risk can cause the most prudent triple bottom liners to flatline. Compliance, socially responsible investments, social impact reporting, environmental responsibility, and economic responsibility to the organization as such as well as to the host country, combined with managing the political risk an organization might face, comprise the business environments in which foreign investment competes for profitability and often the mere maintenance of a market presence.

Some Background to Political Risk Analysis

The measurement and observation of political risk depends to a great extent on subjective human judgment which is in some instances a handicap for political risk analysis. The use of a model for political risk analysis and management aims to “balance” user subjectivity with a model that can reflect researched information in order to attempt a more objective probable estimation of risk. As further events take place and the latest information becomes available, and as past experience becomes relevant, these estimates can be adjusted.

The system of analysis proposed in this book is not an inanimate object – apart from 103 political risk factors and their 411 indicators, it also absorbs the experience and knowledge of its users – people and stakeholders who react and respond to events, and whose views may change, including those of the political risk analyst.

In an attempt to quantify traditionally subjective political, economic and social phenomena in Chapter 5, quantified data presented as weighted factor indicators of risk can be calculated by relaying information into a model designed to reflect the outcome of an operationalized analysis. This model aims to assist during the decision making process surrounding foreign investment, where human rationality is limited when operating in conditions of considerable uncertainty (Simon, 1972).²

One phenomenon still keeping foreign investors away from African countries,

sadly, from those endeavouring to make investment incentives and opportunities attractive is not even risk as such, but rather uncertainty. One way of solving the problem of *not* knowing what is “out there”, is by knowing what *is*. Strangely enough, there is more comfort in knowing what the risks are than not knowing or being uncertain. These threats can then be observed and measured. One is then able to manage risks and plan in the event of them occurring, recognize and anticipate threats.

It is this uncertainty that the model in this book attempts to clarify and alleviate somewhat, as it focuses on developing procedures that may not only enable foreign investors and/or governments to make better decisions, but to *manage* the implementation of these decisions (Brewer, 1985; Crain and Tollison, 1990; Goldstein, Reinhart and Kaminsky, 2000; Makridakis, Wheelwright and Hyndman, 1998).³

Before applying a particular method or model of political risk analysis, it is important to ask about its underlying theory. Political risk analysis and management is mostly grounded in “problem solving theory” (Pidd, 1996). In designing a model for political risk analysis, the relationship(s) between “hard” economic and “soft” socio-political variables should be grounded not only in “tangible” economics, but in social science knowledge and research as well. Risk models should be adaptable and flexible so that they can be reconstructed to suit industry and investor specific micro circumstances. The use of a particular method of analysis greatly influences the investment decision, as well as the reliability and validity of the eventual product of a political risk analysis.

Political risk analysis first became a recognizable field of interest and practice during the mid-1970s, and an initial density in the literature points toward the aftermath of the 1973 oil-crisis. The multi-disciplined⁴ research environment of political risk analysis seemed to have lost its momentum toward the end of the Cold War.⁵ This does not imply that there is no longer a demand for political risk analyses – quite the contrary. There is certainly a need for new research and novel approaches to the field of political risk analysis and the management of such risks. The environment in which political risk analysis occurs has also become more complex. The global balance of power is constantly shifting; multipolarity has replaced bipolarity; new regional groupings have cemented political and economic ideals; and deeply embedded conflicts flare-up repeatedly. Amidst all of this, international trade and its regulating regimes can testify to the more complex structure in which political risk analysis operates. Fortunately, social science methods become increasingly sophisticated, enabling better projections on the basis of available information, while computers have facilitated the accelerated processing of such information and technology, enabling one to gather the latest information via various electronic resources.⁶

There is a need to fill the gap in contemporary political risk analysis research with a model that better represents reality. Causal relationships and analytical procedures are affected by socio-cultural, political and economic phenomena, and should be incorporated into a frame of reference with which to assess political risk.

There has always been a relationship between politics and business, and respect for this relationship enables a better understanding of the risks involved in a particular project. This relationship also forms the dynamic backdrop against which international business is conducted every day. Misunderstanding its delicate nature may result in inapplicable and useless risk analyses. The political risk analyst should be able to advise clients on certain investment opportunities and strategies, and be ready with answers regarding complex decision making environments. Certainly, risks should not only be avoided at all times. By determining the nature and extent of the risks involved, risks can actually be exploited and even possibly profited from depending on the degree to which an investor is either risk averse or risk assertive.

Evidential realities of political risks as contributors to business or investment risk are found in the practice of political risk insurance coverage that is extended to foreign operations by international private banks and political risk insurance companies. Necessary coverage can be calculated by making use of quantitative political risk analysis during the capital budgeting process. Political risk insurance is used as a political risk management strategy where an unfamiliar environment requires attention and assessment before an investment is made. An analytical framework is thus called for which is manifested in a quantitative model for political risk analysis.

As mentioned previously, political risk factors can be of internal (from inside the host country) or external origin, and can pose macro (generic) and/or micro (specific) risks. Political risk analysis should incorporate country risk (explained in Chapter 2) and include indicators of the economic and financial characteristics of a political system. Of course, both the unique and the comparable societal and environmental characteristics of a certain system should also be taken into account before one embarks upon a political risk analysis.

Political risk analysis enables, to some degree at least, a way of recognizing or anticipating political risk, after which a means of managing these risks can be suggested. In this book, this is done by means of identifying risk factors and their indicators, and by determining the relationship(s) between these factors. By identifying, operationalizing and organizing such risk factors, a model can be designed for the practice and operationalization of political risk analysis. In these instances, further criteria should also be accounted for. Such criteria include the types of investments involved, the character of specific industries, the infrastructural environment, and as well as a time frame – how long an investor should wait before commencing operations, or for how long an investment should be made. The management of these identified risks can be conducted in a generic fashion, or whittled down into combinations to suit specific investments or operations.

This book concentrates on political risks that foreign business, be it direct foreign investment, import and/or export operations, private banks, international donors, NGOs, bilateral sovereign loans, joint ventures, or agents operating in host countries might face. In the light of such diverse uses for political risk analysis, a

few can be mentioned at this stage. Political risk analyses can be used to anticipate potential for the imposition of new investment codes, political upheaval that may lead to forced divestiture, or even the breakdown of administrative processes in a country. Comprehensive, valid and trustworthy analyses, comparisons and summaries are useful for assessing the political environments within which various financial decisions for foreign investment must take place. Strategic planning; preliminary viability studies and research; as well as risk management involves identifying trends, and the ways in which the foreign investor can take advantage of those trends profitably (Brod, 1992; Tarzi, 1992).

The Research Problem

Skepticism concerning the operationalization and quantification of non-economic variables, a preference for in-depth single country analyses,⁷ and the lack of clearly defined boundaries for political risk analysis precisely because of its multi-disciplinary nature has resulted in the lack of a systemic approach in the field. This skepticism is based on a belief that political risk is too formless and subjective a concept to be exposed to systematic quantitative analysis (Simon, 1984).⁸

There are some very important questions that should guide studies into the conceptualization, measurement and analysis of political risk. These relate to the notion of political risk itself being made more precise, and revisiting some current methods of risk analysis. It is also worth remedying empirical defects that may arise when measuring “soft” variables traditionally regarded as typical of social science – an area infamous for problems with quantitative measurement.

The primary proposition of this book is that a mathematical quantitative model can measure qualitative givens and present calculated results of a political risk analysis. Some questions that are central to this book will be explored further and expanded upon as the discussions progress, and briefly involve:

- How the notion of political risk can be made more precise.
- Why some present methods of risk analysis are insufficient.
- Empirical problems that may arise in the measurement of “soft” variables or risk factor indicators.
- Methodological problems that may arise and how the model for political risk analysis proposed in this book can be constructed in such a way that the concepts and variables that follow can be adequately operationalized.
- What the importance is of, and problems faced during the sourcing of information for risk analysis and management.⁹
- How the management of political risk can be conducted under decreased uncertainty.

Just as there is a need to enable both country specific and comparative analyses, it must also be shown that combinations of so-called “soft” political, social and even

environmental factors can be empirically observed, measured and translated into numerical terms and equations, and be represented in a compounded result as a calculated risk. The generic model proposed in this book will prove not only useful for political risk analysis as such, but also useful in designing strategies for the management of political risk. The necessity to consider so-called “soft” variables in decision management processes is reflected in the idea to include information that could be regarded as “soft” (such things as people’s attitudes, roles and assumptions) as well as “hard” or technical data (such as numerical data) (Pidd, 1996).

This book’s practical objective is to present a model that can accentuate both isolated events as well as illustrate and map trends. The model can be manipulated to reflect a worst-case scenario, depending on the values fed into the equations. This can be done by choosing to weigh risk factor indicators in an unfavourable way if so required (where each risk factor has its own set of indicators that may or may not point toward the presence of the particular risk factor) thus reflecting the outcomes and consequences of certain decisions. The weight carried by the various risk factor indicators can also be manipulated – should a client wish that socio-economic factors weigh more than other indicator types, this can be done by adjusting the weights of the measurements per formula in percentage terms.

Aim and Relevance of the Book

The main aim of this book is to design and present a generic but adaptable model for political risk analysis – one that takes the latest information and technology, new variables, risk factor indicators and formulas, and combines these with a potential foreign investor’s intuitive judgment and objective expertise (Pidd, 1996). The aim of this model is to offer a service not only to foreign and domestic investors alike, but also to offer lending governments a comprehensive profile of borrowing governments. Other types of foreign investments that can be serviced in this way include capital investments, import/export operations, established operators using agents in host countries, donor agencies, non-governmental organizations (NGOs), large multinational companies (MNCs), or even smaller firms interested in expanding their operations abroad. Also, the model is not designed for exclusive use by “high rollers”, but can accommodate smaller business and organizational interests as well.

Political risk constrains decision making options regarding foreign investment initiatives and should be respected when strategizing around solutions to such constraints. It is thus all the more necessary to make effective and optimal use of limited financial, physical and human resources. The model can also be used as an optimization tool, in the sense that it can be used during a decision making process to optimize the outcome of implementing decisions made regarding foreign expansion.

Some widely-used and reputable approaches to political risk assessments are

lacking in especially three respects, all of which will be addressed in more detail and expanded upon as the discussion evolves. It is worth challenging the notion that political risks are narrowly regarded as being the nemesis of only emerging economies. A traditional and outdated focus on primarily expropriations, confiscations, exchange controls and government instability within developing countries diverts necessary attention away from other vulnerable countries (Brewer, 1981 and 1982; Chermak, 1992; Coplin and O'Leary, 1994; De la Torre and Neckar, 1988; Doyle and Brown, 1988; Mascarenhas and Atherton, 198; Sethi and Luther, 1986). Although a few scholars and economists found mounting evidence for an East Asian meltdown¹⁰ for example, the eventual financial crisis seemed to have taken even the credit rating agencies by surprise (Goldstein, Kaminsky and Reinhart, 2000:45-52).¹¹

The importance of research and the development of viability studies cannot be stressed enough. Based on a solid theoretical foundation, this book takes a practical approach to measuring and managing political risk manifested as risks to foreign investment. It is dangerous to underestimate the importance and necessity of conducting thorough political risk analyses. Assets can be lost due to ignoring or misinterpreting political risks. Foreign investment is not only about making or losing vast amounts of money – investments are also made with regards to time and effort spent on strategizing and planning, investing in personnel, and investments in infrastructure to name but a few aspects that might suffer if political risk is underestimated. If one should “spend money to make money”, the spending of human and financial resources on thorough and in-depth political risk analyses will be justified regarding future investment returns.

The integration and necessary concern with levels and amounts of political risk during capital budgeting processes do not always suffice. Budgeting for thorough political risk analyses is invaluable, and can prevent unnecessary future losses. Another issue facing the multi-discipline of political risk analysis is the separation of the political from the economic, and even from the societal, as done by country risk rating agencies. Politics and economics can hardly be separated from one another, as policy makers and representatives of the governed in any country appropriate scarce resources as they see fit, to whom they see fit, and for reasons they regard as being sensible. Societal insurgence against lowered government social expenditure can lead to civil dissent for instance, and can be relayed back to politics and decision making on the part of government officials.

A repatriation of profits policy in a country might discriminate against foreign enterprises producing the same goods in which the host country has a comparative advantage – again, the notional decision to discriminate both economically and financially against foreign business interests may be relayed back to politics. Fragmentation along ethnic lines and control over resources, language or religious fissures in a once aligned government, and internal threats to regime stability also relay back to politics.

Prior to making foreign investment decisions, strategic planning usually concentrates heavily on economic trends. Since political decisions and events

substantially influence these trends, political risk analysis should be incorporated into these planning exercises. As mentioned before, trends and current events are also widely used in political risk assessments (Anderson, 1991; Dieren, 1995; Hammond, 1995; Todaro, 1992), where trends are reflective of what has been happening in the past, for example:

- If there was evidence of unregulated tropical deforestation, it would be unwise for any foreign organization dependent on wood pulp for production purposes, to make a long-term investment in a country with a heightened deforestation rate not supplemented by vigorous reforestation. Having to initiate a reforestation program in a host country at an investing organization's own expense, will be a cost factor that will have to be calculated into the preliminary budget and expenditures of a possible investment project.
- Private Military Companies (PMCs) might benefit greatly from "doing business" in countries with extreme levels of both offensive and defensive militarization.
- A foreign company in the business of producing oxygen-enriched breathing aids might profit from a city that shows a trend toward unregulated and unrestricted emissions of fossil fuels and carbon-monoxide.
- Limited access to public education and health facilities will impact negatively on the quality of the future labour pool available to a foreign investor.
- The economic impact HIV/AIDS will have on labour turnover and household incomes cannot be underestimated. Costs will be incurred in the ceaseless training and retraining of employees and in lost man-hours due to illness or laborious trips to hospitals and clinics.

Coplin and O'Leary (1994) stress the need of an analytically structured model to sort through the multitude of elements that contribute to the confusion that characterizes politics, society and economics in the vast world of investment opportunities.

The world is not only faced with another century, but another millennium. The changing nature of heightened economic competitiveness will expand to include contenders like international mega-corporations,¹² country groupings and regional unions, and the rapidly changing field of technological progression. Naggling threats become serious problems like global climate changes, the size of the world's population, and HIV/AIDS. Foreign investors, policy and decision makers, governments and international monetary agencies can no longer primarily rely on mere intuitive judgments or pure country and credit ratings, despite the indisputable role these still play.

Didsbury (1993) explains that societies are continuously faced with the consequences of technological change and competition, which have as an effect a greater emphasis on efficacy. An organization's productivity can be in decline in one country, due to, for instance, labour disputes, declining natural resources, government restrictions, a lack of consumerism, or socio-politically motivated actions.

Any combination of the above factors can cause an organization to face financial losses or threaten it otherwise, and the organization might wish to invest in a more profitable, more productive operation in another country. With the decision made to invest in operations abroad, decision makers need to confer with political risk analysts as to the needs of the specific investor and industry. In so doing, the country or investment climate that best suits these needs can be identified and the viability of the investment can be assessed.

With this in mind, the model of political risk analysis presented in this book aims to both ease and fortify the process of conducting political risk analysis by compounding and measuring political, economic, socio-economic, societal and environmental factors as political risk factors of great significance when making decisions regarding foreign investment. The primary users of this model for political risk analysis will find that they can easily apply the model themselves, while mathematical accuracy and facts are not compromised but used simultaneously and objectively with the investor's own experience and expertise – thus marrying quantitative and qualitative elements of political risk. The notion ownership of the analysis process is augmented by an investor's ability to input the scores allocated to indicators by using their own best judgment, and by using the knowledge and experience they have of their own business in their own industries or sectors.

A political risk analyst can be responsive to the needs and requirements of the investor, but only the investor can really fully fathom and evaluate these needs, thus narrowing the communication gap that can possibly come to the fore between the investor and the political risk analyst. The model in this book serves as a suggestion or guide to the investor or decision maker, where his or her expertise, prior experiences and knowledge add immense value to the political risk assessment process.

The analysis and management of political risk is a dynamic subject, as both expected and unexpected events constantly take place against a backdrop of shifting trends and sudden occurrences. Much depends on the world economy and the way in which international politics unfolds. Political risk analysis and risk management is not only concerned with the political and economic events that come into play in a country, but also with the sub-national socio-economic dynamic within countries and the impact world events have on them. Industrialized and newly industrialized countries alike are not exempt from political risk analyses, as the practice of such assessments are not only limited to the analysis of political risks in developing countries. A low risk environment might actually pose a risk in itself. In such an environment where certain political, economic or social risk factors are not present to infringe on profit-taking, there can be heightened market competition in saturated markets, and more investors that are more willing to lend or invest money.

As far back as 1967, Kahn and Wiener (1967) explain that a model for the

analysis of political risk should attempt to offer decision makers the ability to deal with future situations, to be able to lessen blows and exploit an advantageous future. An attempt should be made to design models that are able to cope with futures that might be less likely but that would signify critical problems, threats or opportunities if they materialized.

If a risk assertive or risk averse investor chooses to continue with foreign investment plans after the political risk analysis of a certain country seems to negate the logic of sound foreign investment practice, the investor should at least be equipped with a trustworthy base from which to plan a political risk management strategy in order to profit from a risky situation. This book also deals with political risk management, conceptualized not only in theory but also explained by demonstrating how a political risk analysis model can be used in aiding to manage complexity in order to reduce the risk of making unapprised decisions.¹³ If risk is associated with ways of solving an investment problem, of providing a risk solution and implementation for change in a project's approach, or planning for risk and its eventualities, the model proposed in this book is a most accessible, transparent, comprehensively reflective and flexible political risk analysis and management tool. By having a tailor-made and client specific risk report on one's desk, one is already at an advantage regarding business intelligence.

The rationale behind political risk analysis remains the fact that political dynamics and ever-changing business climates constantly influence and change investment opportunities and profitability. Political risks have to be checked constantly and assessments have to be updated continually in order to provide clients with literally the latest and most thorough political risk analyses. Existing reputable rating methodologies are good assessments of country risk analysis as such in themselves, but do not suffice in terms of calculating or comprehensively covering all possible types of risk, and as this is not their intention, it becomes necessary to design a model with such intent. They are mostly macro risk rating tools, and are very useful to lending and financial institutions, and for macro-economic policy evaluations. The balance of payments sheet, financial indicators, and other macro-economic factors taken into consideration in the above methodologies, do not exist in isolation from the political system of which they are a part and in which they function. They are influenced by the same factors used in this book of political risk analysis, if not products of these, where politics refers to the authoritative allocation of (scarce) resources, be they financial or physical. Still, country risk factors should in fact be used if comprehensive political risk assessment is a desired outcome.

Country ratings are often mistakably used for purposes other than those they are actually and expertly intended for. Such ratings are often applied as comprehensive reflections of a country's overall investment climate, instead of the purpose they were designed to fulfill – that of *credit* rating. The dangers inherent in such practices are mentioned briefly in this instance, but are further expanded upon in a following chapter.¹⁴

It is irresponsible to present a client with a risk assessment that does not incorporate economic as well as political risk factors, let alone environmental, societal and socio-economic factors of political risk. The balance of payments as a tool for credit risk assessment, although a useful tool in political risk analysis as well, does not suffice for use as the *only* assessment tool. An analysis using this and a few other macro-economic and financial indicators is valid for the purpose of country or credit risk analysis, but not entirely reliable as a political risk analysis. Not taking political factors and their indicators into account is taking further risk in an already complex decision making environment. Not incorporating political risk factors will not “undo” the impact that the political environment might have on foreign investment, or, as in the case of the Asian crisis, the impact that the micro political environment might have on markets. Ultimately the business climate, regardless of the country, is underwritten by the political system, political climate, as well as the political and business culture of the system in which foreign business wishes to operate profitably.

The analysis of historic events in a country or of certain current events may lead to a realization of the circumstances under which threats to foreign investments can occur. The reason for making such a projection is to prepare or warn the investor as to how an organization can anticipate, recognize and deal with such risks or manage them. With political phenomena as a subject of analysis, the analyst is dealing with the behaviour of those people who make up Government, who legislate, judge and execute the rules and regulations, and influence the making of laws they choose to establish. The political risk analyst also has to take into consideration the social reaction to such government behaviour and rules, as well as the ability of the political system to respond to and cope with the taxing demands on and events in its domestic and international environments.

These taxing demands and inputs into the political system are better dealt with in a highly consolidated system that has experienced steadfast and evolutionary political development. The consequent policy stability thus contributes to a more “predictable” and profitable business environment in which foreign investors can operate – a business environment that is unconditionally linked to the political system of which it is part.

The political risk analyst thus tries to anticipate and calculate the probable size or magnitude of loss a potential investor might incur by envisioning the flow of interwoven circumstances under which such losses might occur. Those circumstances are then anticipated against the backdrop of features that pertain to the specific country, industry or environment in question. This book not only concentrates on the analysis of political risk, but on the post-analysis management thereof – on identifying both risks and opportunities. Yet the analyst needs a model that serves as a map of reality in order to guarantee the most effective and trustworthy risk assessment reflective of the identified risk factors that apply to a certain industry or environment in a country.

Methodology or Madness of Political Risk Analysis?

Various methodological difficulties arise when conducting political risk analysis. The importance of modelling the analysis so that the concepts, variables and risk factor indicators that follow the modeling process can be adequately operationalized should not be underestimated. Methodological problems experienced in political risk modeling will be addressed in more detail in the next chapter. Uncertainties surrounding the validity of political risk analyses relate to the mentioned skepticism experienced with political risk analyses to date. Yet it is possible to measure political risk and to operationalize identified risk factors and their indicators by designing a model in aid of calculating political risk, as this book attempts to show.

Both qualitative and quantitative in nature, one of the main aims of this book is to show how these two approaches can be used in conjunction with one another by “marrying” the qualitative nature of “soft” variables and the more quantitative “hard” variables into comprehensive political, social and economic factors of political risk. The book will show how qualitative variables can be measured and quantified, by attributing weights to risk factor indicators. These weights are then calculated to present a measured, probable chance that political risk might occur. The quantification of both the “hard” and “soft” variables actually takes place during the operationalization phase of the book, that is, in designing and applying the model.

This book will span across all three elements of the purposes of social research, these being descriptive, explorative and explanatory (Babbie, 1995). The units of analysis are mainly taken from two levels of data or observation: from an individual level, and an aggregate (or ecological) level, denoting individual units of analysis and groups respectively. Although the next chapter deals with methodological and theoretical problems encountered in the book, the levels of analysis problem (as opposed to the levels of measurement being the nominal, ordinal, interval and ratio measures, De Vaus, 2001; Johnson and Joslyn, 1995) should be mentioned at this stage.

Neuman (2000) explains that a level of analysis is the level of social reality to which theoretical explanations refer, and delimits the kinds of assumptions, concepts and theories that a researcher uses. Levels of analysis relate to the types of observations and measurements that will be applied in the quantification of political risk factors in this book, and to the reliability and validity of the conclusions that will be drawn from these measurements, where reliability refers to dependability or consistency throughout the research process suggesting that the same thing is repeated or recurs under the identical or very similar conditions. The term “validity” as used throughout the book suggests truthfulness and refers to how well an *idea* about reality “fits” with *actual* reality (De Vaus, 2001; Johnson and Joslyn, 1995; Neuman, 2000).

Units of analysis refer to the type of unit a researcher uses when measuring

certain phenomena (Neuman, 2000). These can be an individual, a group, an organization, a social category, a social institution or a society. Depending on the type of research question, the unit of analysis can also be a state, a speech made by a political executive or changes in foreign policy over time.

These levels of analysis errors are actually made up of two fallacies, namely the ecological and individualistic fallacies. The levels of analysis fallacies are important to bear in mind, especially in regard of the fact that macro (balance of payments sheets for instance) and micro factors (industry specific indicators) of political risk do not operate in isolation from one another, but in a “dependent” fashion, constantly impacting upon one another.

The same can be said for the environments in which these factors operate namely the macro and micro environments – they are interrelated, and one environment cannot effectively be shielded against events that take place in another. It should be noted that the initial definition of the levels of analysis one is working with, as well as the “environments” they are taken from, is of crucial importance. It follows that, in order to enable effective, valid and credible political risk analyses, what should be clearly identified from the outset is precisely which environments and levels of analyses are being addressed in each individual analysis.

The model presented in this book can be used to recognize and identify, examine and even monitor trends and cycles over a period of several years, permitting observations in political, economic and social changes within a host country over an extended period of time. This does not negate the notion that the model presented in this book can be used for in-depth country comparisons, and its uses can be both synchronic (countries are compared simultaneously at one point in time in an attempt to identify the better investment option) and diachronic (where an analysis of a certain country is done across time, thus enabling trend studies) in nature, depending on whether the need for the analysis is an in-depth country approach or a more comparative approach.

However, certain limitations to the book are introduced due to the focus of the research conducted, in the sense that the number of risk factors used in the generic model for political risk analysis in Chapter 4 has been limited from an inexhaustible pool of risk factors to a certain amount. Limiting the number of risk factors used in the model design illustrates the adaptability function of this book’s generic model. As the consequent specific model can show, the number of relevant risk factors can either be further reduced or increased. Yet due to the scope of this book, the risk factors have been limited to those used in the generic model. The reason for this being that there is actually an infinite multitude of combinations and varieties of risk factors that can be used when designing a model for political risk analysis. By no means is it asserted that a set of risk factors will ever be complete or eternal, but will hopefully prove useful, and to which further research might contribute.

In light of this and the necessarily limited scope of the chosen risk factors, this book concedes that there might be a relationship between its area of interest and

another part of reality that is missing from the model. The model presented in this book is neither trivial nor fully requisite. Instead, it aims to simplify (not oversimplify, though) and contextualize the complexities of reality-based investment environments.

Pidd (1996) maintains that model validation, if taken to mean a comprehensive demonstration that a model is fully correct, is short of impossible, and regards validation as an ideal towards which one must strive in adherence to the idea that management science aims to support action in the real world. It is important to note that it matters whether models are wrong, as this may cause potential investors to embark on actions that have extremely negative consequences.

The Remaining Chapters

This first chapter touched on some of the terms, issues and problems that will be investigated in much greater detail as the discussions evolve. The problem statement was addressed in the first chapter, as well as the importance of the book. The second chapter deals with a conceptualization of the terms used throughout the book, as well as its theoretical approach in an attempt to establish the theoretical base of political risk analysis. It is the contention of this book that political risk analysis is founded in problem solving and decision making theory, both of which will be explained in the next chapter. An additional focal point of the second chapter is the sources of data – not only of this particular book, but also of “good” political risk analyses in general. Chapter 2 also addresses various theoretical and methodological problems encountered by political risk analysts.

The third chapter deals with some current risk analysis methodologies, and presents as well as discusses some implications for future research on political risk analysis brought to light by the example of the Asian Financial Crisis (AFC), and also addresses the notion that macro-type rating models did not send off any warning signals. Chapter 4 deals with the political risk factors and their indicators used in the book, why these were chosen specifically, how they are weighed as well as how to score these indicators in the presented model.

In the fifth chapter, the mathematics behind the model is presented, and the model itself can be tested. Chapter 6 introduces the notion of political risk management, which is possible after having identified potential risks by means of the designed model. Important to mention is the idea that the quality of the risk management strategy is only as accurate and reliable as the risk analysis. Thus, the design of the model that is covered by the preceding chapters challenges the model to reflect such accuracy and validity. This book concludes with the seventh and final chapter, which offers some closing remarks and allows for further discussion relating to further scope for research in the field of political risk analysis.

The ultimate practical objective of this book is to offer a model for political risk analysis, accentuating both isolated events and trends. The model can also be manipulated to reflect a worse-case¹⁵ scenario, depending on the values scored into

the equations, by choosing to weigh risk factor indicators in an unfavourable way if so required. Weekly results can be tabulated or graphed to illustrate trends or tendencies, and monthly or annual tabulations can show cycles – assisting in anticipating and planning for risks involved in international business.

This model can also be used in a reverse analysis, or “backward working” fashion. If a client knows exactly what the ideal environment “looks like” for the viable and profitable implementation of an investment decision, the model and accompanying analytic methodology can be used “backwards”, thus tracing the ideal conditions by means of identifying the ideal weights of the risk factor indicators, and then matching them up with possible investment environments.

It remains to be seen if the model proposed in this book can pick up on micro factors indicative of a looming crisis, and if future Asian-type crises can be avoided. Of course, if they do not take place, due to the pre-emptive measures that can be taken on advice of the model, it suggests that this model can also serve as an early warning instrument in itself.

In summary, this book offers a comprehensive model for use in political risk analysis. It combines macro and micro political risk factors and their indicators, and draws these not only from the political environment, but also from the economic, financial, physical natural and socio-economic environments. The model can be used to do in-depth country analyses, or can be adapted to enable cross-country comparisons and interactive industry-client specific analyses, and in doing so, augments the client-ownership of the risk assessment process.

What is often labeled as unnecessary and irrelevant detail in political risk analysis often results in the lack of using micro risk factor indicators, and an underestimation of the importance of such micro risk factor indicators. This book will present an example of political risks that business or government might face in their involvement in investment initiatives.

This book takes up the challenge of showing that political risk analysis can be made more precise, that it *is* possible to measure and manage political risk. In doing so, it also attempts to remedy empirical defects that arise when measuring “soft” variables, traditionally regarded as typical of social science – an area infamous for the near impossibility of quantitative measurement.

Notes

- 1 This is a broad definition which aims to show that the factors addressed in this book as agents or indicators of political risk are not purely and necessarily *political* in nature – they can be socio-economic, socio-political, macro economic, financial and even environmental in nature. Indications of an over-powerful, unchecked and unbalanced executive prompt an analysis of the person as well in order to anticipate possible actions, statements or decrees. Although conceptual details will be offered in Chapter 2, see the following sources for temporary clarification: Akhter and Lusch, 1987; Baker and Hashimi, 1988; Bird, 1986; Brewer, 1985; Broadfoot, 1998; Chermak, 1992; Coplin and O’Leary, 1994; Fitzpatrick, 1983; Frei and Ruloff, 1988; Kobrin, 1981; Krayenbuehl, 1985; Sethi and Luther, 1986; Simon, 1982.
- 2 Awarded the Nobel Prize for Economics, Simon (1972) based his ideas of human rationality and decision making processes on observations of the ways in which

decisions are *actually* taken in practice. In this book, the model for political risk analysis aims to assist in the decision making process and eventual clarification and management of the complex environment in which such decisions are made.

- 3 Additionally, see Mueller in Rodgers (eds.), 1988; Rice and Mahmoud, 1986; Simon, 1985; and Somerville and Taffler, 1993.
- 4 Political risk analysis draws on information traditionally assembled by economists, historians, political scientists, behaviouralists, and in many cases, environmental economists, strategic managers, financial analysts, international relations theorists, development theorists, international political economists and public policy makers.
- 5 The bulk of research and publications on political risk and political risk analysis was mostly done in the 1980s.
- 6 The sensitive balance between credible academic sources for arguments sake, and background, evidential or illustrative information taken from the Internet – among other sources – will always be carefully maintained in the spirit of academic research.
- 7 Although this book by no means negates the absolute use and need for in-depth single country analysis – and even facilitates this practice by enabling such analyses by means of the suggested model – it does propose, however, that certain benefits can be derived from using in-depth analyses comparatively.
- 8 Also see Brewer, 1981; Chermak, 1992; De la Torre and Neckar, 1988; Doyle and Brown, 1988; Mascarenhas and Atherton, 1982; as well as Sethi and Luther, 1986.
- 9 The management of political risk analysis will be dealt with in great detail in Chapter 6 illustrating that once the decision to invest has been made based on a methodological analysis, the implementation of the decision is less simple given the various complexities faced in different investment environments.
- 10 See Krugman (1994) in his informative explanation of the myth of the Asian “miracle”.
- 11 See Goldstein, Kaminsky and Reinhart, 2000; Fitch IBCA, 1988; Luce, 1998; South China Morning Post, 21 January 1998; Tesoro, 2000; and the Economist, 15 July 1995 and 13 December 1997. The 2002 Enron crisis in the United States of America has also prompted criticism against rating agencies (Larsen and Wiggins, 2002).
- 12 Like petroleum companies such as British Petroleum, Royal Dutch/Shell Group, and Exxon/Mobil. Others include Nestlé, Unilever, Siemens, Philips Gloeilampenfabrieken and major motor vehicle manufacturers, and electronics manufacturers. Michael Todaro (1992) compares the GDPs of some countries with the annual turnovers of large MNCs in his book “Economic Development in the Third World” (Fourth Edition, Longman). Although the data stems from a 1985 sampling, the illustration shows how the annual turnover of some MNCs (especially petroleum related) is larger than the gross national product of some countries with mid-size economies. Granted, “smaller” countries have relatively small economies, but to service an illustration of the point, the annual turnover of General Motors for example, was larger than the annual product of Switzerland; and Toyota Motors annual product was larger than that of New Zealand in 1985. Of course, there are advantages to the establishment of MNCs in host countries, but this book would be biased if the disadvantages of such foreign investments were not considered and investigated...this is done in Chapter 2.
- 13 This book will aim to show how a model for political risk analysis can aid in the post-decision making process, by having identified and calculated possible risks, and thus mapping the way forward in navigating around these risks
- 14 Goldstein, Kaminsky and Reinhart (2000) express their thoughts on the dangers of using sovereign credit ratings incorrectly.
- 15 Where a model, per definition, enables the user to investigate what might happen if a decision is made, one way or another.

Chapter 2

Thinking About Political Risk: A Conceptualization

Introduction

This chapter deals with the conceptualization of terms used throughout the remainder of this book and attempts to establish the theoretical base of political risk analysis. Although mention has been made of some of these terms, those explored in greater detail in this chapter all refer to the practice of political risk analysis as such, in an attempt to gain greater conceptual clarity on the definitive meaning of *political risk* and the *analysis* thereof. These terms include “country risk” and “political risk”; “problem solving theory” and “decision making theory”; the process of “analysis” as such, “model”¹ and “modelling”; as well as the nuanced differences between “predicting”, “forecasting”, “forewarning” and “anticipating”. This chapter will also attempt to further clarify and explain some methodological and theoretical problems encountered in political risk analysis, such as the levels of analysis problems briefly mentioned in the previous chapter.

Thinking About Political Risk

Although conceptualizing the terms used in this book entails much more than merely defining them, a definition² is, in its most basic sense, a description of an object or term that explains how its characteristics make it different from any other. This should also clear up the question of what political risk “*is not*”. This chapter will discuss that which makes political risk different from other kinds of risk, like country risk for example. It will also explain those “characteristics” of political risk that will make it possible to recognize and perhaps even be able to anticipate such risk.

Chicken (1996) explains risk as the manifestation of doubt regarding the frequency and consequences of undesirable events, and risk management as the outcome of plans or strategies implemented to maintain an acceptable level of risk associated with an investment project. Miller (1991) uses political risk as an example of a term that links unpredictability of investment performance to specific uncertain factors of the investment environment, where uncertainty about both environmental and organizational variables impact negatively on the ability to

predict corporate performance, thus increasing the probability of risk occurring.

It becomes important to start differentiating between country risk and political risk. It is necessary to clearly define the difference, as this chapter will suggest that country risk factors could be included as variables in a political risk analysis as well, although the political risk factors put forward in this book are hardly ever used as indicators of country risk. A multi-discipline in its own right, political risk is a specialized cousin of country risk – using the two in tandem during a project profiling process can prove invaluable. It is thus useful to mention some of the more widely used terms and scrutinized definitive questions of political risk and the analysis thereof.

Many political risk authors begin by accounting for the diversity and the discrepancies of the existing definitions of the multi-discipline. This might be partly due to some critique regarding the clarification of the concept/definition of political risk as being a problem of nominal versus real definitions.³ *Political risk* as such is a nominal definition, as are many other concepts in social science, and the reason for contestation in political risk analysis is exactly due to the nature of nominal definitions. This book's discussions continue in awareness of the limitations that the very nature of nominal definitions can place on empirical studies.

Still, most political risk authors seem to agree that political risk broadly supposes *the probability that business will either earn less money, or suffer losses in profit as a result of stakeholders within a political system's (in)actions or reactions to events, decisions and policies* (Brewis, 1985; Brummerstedt, 1988; Coplin and O'Leary, 1994; Fitzpatrick, 1983; Frei and Ruloff, 1988; Hertz and Thomas, 1983; Howell, 1986; Kennedy, 1991; Kobrin, 1978; Rummel and Heenan, 1978; Simon, 1982).

With regards to smothering profitability by actors other than the investor, private insurance markets agree on the traditionally insured political risks as being host government action that may include nationalization or expropriation; restrictions on profit remittances; contract repudiation; forced divestiture or even forced abandonment. Although International Law recognizes the sovereign right of any country to expropriate foreign investment or private property, this can only be enacted if such an action is lawfully compensated; not discriminatory; taken for a public purpose; taken in accordance with due process; and not in violation of specific contractual agreements with the contractor of such licenses and concessions (Dealmaker, 2002).

Foreign investment within a host country concomitantly brings with it the need for transferring currency in the form of dividends or profits (Dealmaker, 2002). During an economic slowdown, political risks could increase due to the need to retain hard currency within the country. A profitable, self-sustainable foreign-owned entity might prove all the more attractive to the host government. It is for this reason that political risk insurance clauses are included to ensure that host government actions do not impact negatively on (or smother) a company's profitability and operationability.

Selective discrimination manifesting itself as micro risks, a law, order, decree, regulation or import/export restriction applied selectively by a host government against an investment project or foreign organization and *not* against any locally owned entities conducting similar business, can wholly obstruct the viability and profitability of a foreign investment project. For example, being able to import the necessary drilling equipment to enable the extraction of minerals for export purposes can “make or break” an investment. If any such discriminatory act is practiced the foreign organization can become financially deficient. This illustrates how the probability of an adverse government action could increase risk due to a need to retain hard currency within the country during an economic slowdown, for instance (Dealmaker, 2002).

Risks within countries can change on a daily basis and a strategic contingency approach to eliminating these can prove invaluable.⁴

Political risk is unfortunately easily confused with country risk, which in turn can be defined more precisely by referring to sovereign, credit and transfer risk. Country risk differs from political risk in the sense that country risk can be explained as potential financial losses due to problems arising from *macro economic* events in a country (Calverly, 1985; Coplin and O’Leary, 1994; Kennedy, 1991; Krayenbuehl, 1985). Balance of payments sheets, country credit worthiness, and data on debt servicing ratios are the most widely used tools in country risk analysis. Coplin and O’Leary (1994) comment that too many current models of risk analysis focus too narrowly on these aspects, and in doing so, disregard combined political, economic and social micro risk factor indicators.

Political instability and political uncertainty are properties of political risk, where the former refer to biased uncertainty about the probability of political events taking place (Beroggi, 1999; Rummel and Heenan, 1978; Schneider, 1985). Basically, political uncertainty, according to Howell (1986), results from an inadequacy of information, whereas political risk is rather a more objective measurement of the *amount* of doubt, in contrast to the more subjective nature of instability and uncertainty. Political instability refers more to unexpected or unforeseen changes in leadership succession, government policy, or in a government’s implementation of power.⁵

Political instability, in this book, is used as one criterion that points toward the probability of political risk occurring. Foreign investors should be advised to either carefully manage or avoid operating in a context of physical conflict that might evolve from political instability. The underlying risk that political instability holds for a foreign organization is the possibility that political disequilibrium might result in governmental limitations on producing profits.

Not only is political instability a political risk factor that can contribute to losses incurred by foreign investments, such losses can also be a result of host government nationalization and confiscation actions, the repudiation of contracts or even a loss of mineral rights for investors in the extraction industry of a host country. Another political risk factor would be the imposition of harsh import and export restrictions, currency regulations and controls over employment practices.

Further losses can be reflected in labour turmoil, lost man-hours, theft, war damage, even acts of subversion, looting or vandalism, or other actions taken in reaction to government policies. To gauge the possible threat of nationalization and confiscation necessitates not only knowledge of a host country's political structure, but the philosophies and personalities of the political management and its elite should also be taken into consideration (Kennedy, 1991; Venter, 1997), as should knowledge of the society, culture and the influence of differing political ideologies and even theocracy in parts of a country where foreign investment is planned to take place.

As explained previously, political risk is not only present in macro environments, but can also be industry (micro) specific (Akhter and Lusch, 1987; Anderson, 1991; De la Torre and Neckar, 1988). It can vary among different industries within a single country, depending on the nature of the foreign investment and the kind of market it wishes to enter. Some organizations may offer goods and services that become crucial to the direct functioning of the host economy, such as public service providers or crop growers. Even the production of rutile used in cellular telephones and laptop computers becomes an issue in countries like Sierra Leone and the Democratic Republic of the Congo. Organizations that play a critical role must be aware of the danger of being subject to government demands due to a feeling of resentment against foreign dominance or exploitation by foreign economies.

Confiscations and nationalization of foreign-owned industries, although aged factors of political risk yet perpetually important, are but two factors of risk in a very expansive political risk spectrum. Subsequent forms of host country interference include insisting on the use of local nationals in management jobs regardless of merit or experience, or discouraging the purchase of a foreign firm's goods. Sanctions, such as imposing taxes, royalties or other impositions, can be instructed against foreign firms to the point where being a profitable organization is only possible with great difficulty, if at all. As an example, non-tariff barriers might include petty quality standards, or over-ambitious health and safety regulations.

It is not only the host country that poses risks to investments, but the type of investor and the nature of the investment itself that also brings certain risks into transactions in host countries. For instance, American business as a symbol of western values might suffer deliberate non-purchase out of principle or protest in Islamic countries. Business people are usually associated with money, and might warrant large ransoms if kidnapped (Macko, 1997).⁶ Depending on the nationality of the foreign partner, entering into a joint venture with a foreign investor can even be risky for the local partner from the host country. These are risks that country risk analyses do not necessarily take into account. They are also risks that, if unplanned for and unmanaged, may pose threats in the sense that losses in profits or to life may occur due to otherwise manageable events impacting negatively on foreign business and business people.⁷

In order to further conceptualize political risk, the mentioned interdisciplinary

nature thereof has to be kept in mind.⁸ An awareness of an investment scenario includes updated knowledge of the country in question's politics, history, culture, law, economics and international relations, as well as knowledge of the investing firm's likely role in the host country's economy and its impact on the environment and on society. Ironically, this complex interdisciplinary nature of political risk analysis might even have contributed to the gap in research published during the greater part of the 1990s.

Although political instability and political uncertainty are mentioned as negative contributing factors to political risk, uncertainties can be regarded in a positive light. If risk encompasses any actions of which the consequences are uncertain, then chances taken in a positive or profitable environment should be rewarding. If these uncertainties are managed accordingly, the possibility of being able to exploit them becomes a reality.

The presence of political risk factors does not necessarily, or by definition, have to show negative results. It can, in fact, expand on positive post-analysis conclusions reached about certain foreign investment ventures. It follows that the presence of manageable levels or "types" of political risk can even encourage certain investment endeavours. This is why a model of political risk assessment should enable both client specific as well as in-depth comparative analyses – to compare the results of various macro and micro risk reports, and eventually select the most positive post-analysis result as indicative of an investment opportunity. If uncertainty refers to a lack of predictability, then both positive and negative investment environments present uncertainties that one can strategize around. This can be done by modeling for political risk analysis, and by post-analysis risk management planning.

If political risk supposes the probability that a certain event or factor might impact negatively on the returns of foreign investment, then it should follow that the degree of risk is related to the "size" of the probability factor. That is, the higher the probability of risk occurring, the greater the risk and the greater the return. Although the traditional focus of political risk analysis seems to be on possible losses, variations from these expectations in the forms of gains from political events or phenomena can also be factored into political risk assessments.

Depending on the nature and origin of political risk, external risks can impact negatively on both foreign and domestic firms in a country, while internal risks might only affect foreign investments. Political risk thus also suggests severity, and as suggested by a risk-balance matrix in Chapter 6, *a degree of impact that governmental (in)action or societal (re)action, originating either within (internal risks) or outside the host country (external risks), can have on foreign and even domestic business operations and investments.* And where country risk as such is said to encompass the *total* risks, non-business *and* business that a host country poses to foreign investors (Howell, 1999; Leavy, 1984), then political risk is a specialized relation of country risk. It remains the contention of this book that country risk as practiced by reputable credit rating agencies does, in fact, not sufficiently incorporate non-business risks (like political, social, and environmental

risks), and if some do, then to a degree that does not warrant comprehensive risk analysis. Although not called political risk ratings as such, such ratings can be mistakenly used by prospective investors as a comprehensive reflection of a country's investment climate. Due to either a very small or completely absent section on political risks, it is necessary to offer a risk assessment model that can incorporate both country and political risk factors extensively and comprehensively.

The scope of this book specifically focuses on political risk, but in order to further service the contextualization thereof, it seems only fitting to expand on what country risk is in order to better understand what political risk entails.

The Difference(s) Between Political Risk and Country Risk

The main actors in *country risk* as such are countries petitioning for loans, and those (private) banks, states or monetary organizations that are willing to grant those loans. If the borrowing country fails to service the repayment of these debts, or is unable to service the interest on these debts, lending money to such a country would pose a certain degree of risk (Krayenbuehl, 1985).

At the encompassing country level of risk there are essentially two types of risk – sovereign and transfer risk (Calverly, 1985) which, in the model put forward in this book, also act as political risk factors resulting from government (in)actions/reactions. These are included to ultimately enable a more comprehensive and overall reflective assessment of a country's investment climate, incorporating both macro and micro economic, political and social risk factors for use in conjunction with established credit rating methodologies, or parts of which can be incorporated into future rating methodologies. Roberts (1986) further augments this idea in describing how country risks result from inappropriate politics and economic policies that devastate the domestic economy and lead to balance of payments crises or even political upheaval.

It follows that creditworthy countries with a good repayment record pose less country risks, and are more likely to receive further loans than countries experiencing problems with creditworthiness (Bird, 1986; Calverly, 1985). Most of the reputable credit rating agencies do not gauge a country's *willingness* to repay loans, do not conduct political risk analysis as it is defined and modelled in this book, but rather conduct *country risk analysis*. These ratings are expert and excellent reflections of credit rating and credit risk as such, but are often unknowingly applied as reflective of political risks as well.

In cases where some of the credit rating methodologies do incorporate political risk factors, they are mostly limited to ten or fifteen political risk factors, and perhaps function better as indicators of country risk. To use credit ratings as a tool with which to *comprehensively* forecast investment climate behaviour is a dangerous practice, as these ratings should rather be used as an indicator of country risk at a specific moment in time.

Although a useful factor for political risk analysts as well, the balance of payments mostly mirrors the data country risk analysts need in order to establish a country's debt service ratio, loans as percentages of gross domestic product, the size of reserves, or capital and current account credentials. These statistics supply the necessary "tools" for country risk analysis, but are only some of the listed factors and their indicators that comprise political risks.

In a basic sense from a country risk perspective, country risk implies a country's *inability* to repay loans, whilst political risk relates to a country's *unwillingness* to do so. Levels of political risk in a country are not necessarily pegged to levels of country risk and *vice versa*. A country can experience relatively little country risk, but relatively high levels of political risk. Often instances of political risk are short-term, in other cases they are prolonged and chronically symptomatic of a specific country.

Figure 2.1 illustrates the relation of political risk to country risk. At least from a general country risk perspective, a country might be unwilling to repay a loan despite being able to do so. This points toward a political risk problem in the sense that a government is unwilling to repay loans, be it for ideological or other reasons. A country might be willing to repay loans, but is not able to do so. This does not necessarily point toward a political risk situation as much as it does to an amalgamation of various credit difficulties.⁹ Still, a case of low transfer risk combined with high political risk needs to be scrutinized very carefully in a country identified as a possible destination for foreign investment.

It becomes clear that country risk issues occur when there is a breakdown in either a country's willingness or capacity to service a debt (Calverly, 1985; Lahiri and Moore, 1992). The distinction between intended (un)willingness and (in)ability to repay is important, though sometimes difficult to differentiate – this is where political risk comes into play. For instance, a country which is able to meet its repayment obligations might be unwilling to do so on political grounds, hence a political risk, as this (hostile) action might be indicative of further politically motivated government actions that might impact negatively on foreign business. A loss of trade finance, boycotts, sanctions and the arrest of foreign assets could be an expensive payment in itself for a purely political or ideological end.

Yet it seems that a country's ability to repay loans is usually linked to the political will to do so. A borrowing country might not be willing to see a process of structural adjustment through as a conditionality to an improvement in the balance of payments. Government might anticipate that cutbacks in social spending could result in civil unrest, thus possibly increasing the levels of political risk within a country in turn. Country risk thus relies greatly on the components of a country's balance of payments. Often though, fluctuations in these components are really symptoms of more deeply manifested policy problems that are identifiable by doing a political risk analysis of, for instance, displays of earlier mistakes or of deeper underlying problematic trends.¹⁰

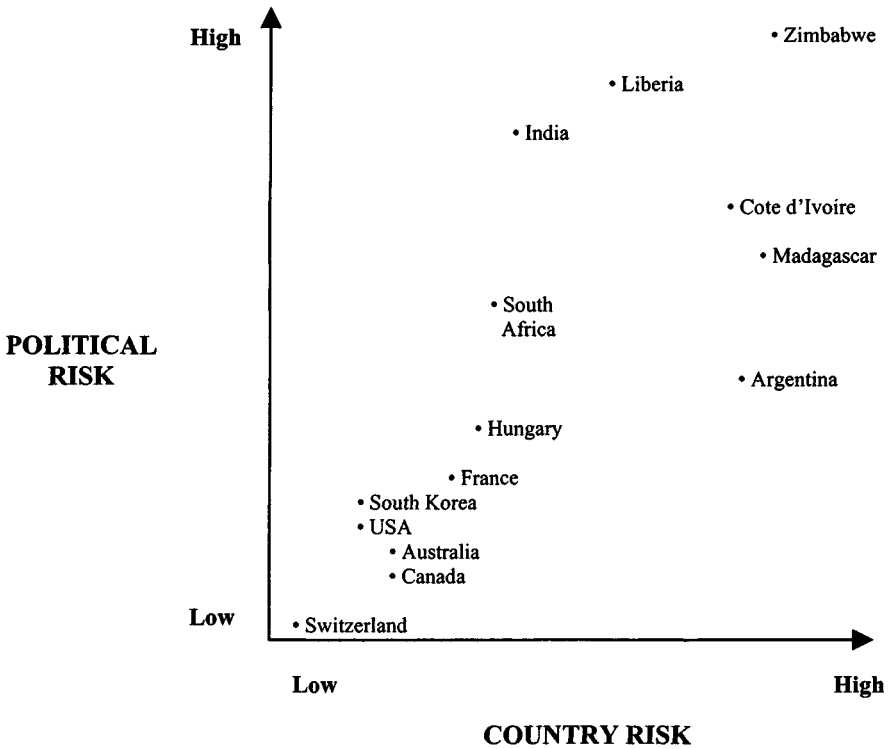


Figure 2.1 The relation of political risk to country risk

Export shortfalls for instance, are reflective of the composition of exports or the dependence on a narrow range of goods and services. Export performance may in turn reflect the structure of the economy, or the (in)effectiveness of economic management. Capital flight and divestiture are results of more piercing issues. Concern over the course of the economy, or political risk posed by domestic political events, can encourage the outflow of much needed capital (Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992).

The slow or inadequate response of a government to an economy in trouble is a political risk factor, where this is usually due to an underlying political weakness that might have prevented, and will in future prevent, strong political and subsequent economic leadership. Although countries experience recurring economic patterns often in response to global economic cycles, risk is still mirrored in the alarm that the economic upturn of a certain country will be too slight or too late to deal with the problems it suffers, thus posing risks to foreign investors. Political risk analysis is in fact enriched when expanding on its link to country risk.

The Analysis of Political Risk

The analysis of political risk not only aids in describing political phenomena in terms of factors of risk, but also tries to explain or understand the occurrence of political risk. The term "analysis" denotes historic, current, as well as future investigation, and aims to interpret something in terms of its effects. Political risk analysis is a process in which investment potential is measured against the backdrop of certain factors which contribute to levels of political risk in a country. In a very basic sense, should one take political risk factors and apply them to a specific country thereby drawing a conclusion as to whether a country does indeed pose possible political risk to foreign investment, the measurements of political risk factor indicators try to explain the political risk situation in a certain country and a political risk assessment of a certain country is made.

At this stage of the discussion, political risk *analysis* broadly encompasses *the examination and explanation of the probability that interrelated factors caused or influenced by government political decisions, (in)actions, reactions, or other unforeseen external or internal events will affect business and investment climates in such a way, that investors will lose money or not make as much money as they expected when the initial decision to investment was made.*

In order to conduct such an analysis, one needs to isolate the risk factors that will be used when modelling the analysis. A high level of political risk in a certain country can stop an investor from spending any amount of investment capital. These factors and their indicators shall be discussed in great detail later, but in the meantime, some of these factors include failed states, states of emergency or rebellion, or states in transition; quality and culture of law; political instability; the erosion of support for government and governance consent; external, internal or border disputes; military mutiny, fiscal and monetary decisions overwhelmingly influenced by ideology, foreign policy and international relations, and leadership succession issues.

Other factors that contribute to the presence of political risk include low levels of adult literacy; uneducated or unemployed politically mobile workers; and even the depletion of scarce resources as indicative of a country's economic prospects. The political and economic threat of HIV/AIDS cannot be ignored either. Apart from the pandemic causing illnesses that can lead to lost man-hours, it becomes necessary to spend vast amounts of money in re-training new employees to fill positions lost to HIV/AIDS. This disease poses a risk to investment capital, especially in regions of the world where the density of the disease is considerably high in the population and consequentially in the workforce. The impact on the cost of insurance, health care and the costs to households will be immense.

In order to conduct valid and reliable political risk analyses, one also has to be aware of the pitfalls that an analyst is likely to encounter in order to avoid, accommodate or remedy these problems. Factors that contribute to the validity and reliability of analyses will be mentioned in the following section.

"Good" analyses

Certain standards have to be upheld during the process of analysis in order to justifiably state that the results of an analysis can indeed be deemed valid and reliable. Applicable results assist greatly in the trustworthiness of political risk forecasts, and the analysis itself must thus be both comprehensive and comparative.

It is also necessary to keep policy relevance and the nature of the investment in mind when conducting political risk analyses, by means of carefully considering the needs of investors, and how those needs can be met in the light of gauging industry-specific micro risks. The risk factors under consideration must be useful and specifically designed to aid the decision maker in considering different investment opportunities. Both internal and external events contribute to the occurrence of political risk, and are constantly influencing the severity and degree to which risk factors influence investments. Perceptions of political risk are also vulnerable to change, as the world economy and international politics constantly unfold into new configurations.

Still, Calverly (1985) asserts that political risk analysis has to be based on fundamentals, for without a full appreciation of a certain country's political and economic systems, it is not possible to anticipate the likely reaction a host country might have to shifting world or even domestic developments. It is also vital to identify key vulnerabilities even if circumstances present themselves at the time as being favourable. Any dependencies pose future vulnerabilities as they are requisites to which dependent countries must adhere; be they reliance on oil imports, the export of single commodities, dependence on capital inflows, a weak political system, or civil tension and unrest.

It is often the case that the results of a political risk analysis are seen as representing an average of the likely outcomes of the used factor indicators, but this may not always ring true. If a political risk assessment shows a country as having several potential problems, but no one outstanding vulnerability, then it may be appropriate to judge it as a "moderately good risk" (Bray, 1994; Calverly, 1985). It may so happen that countries are analyzed as posing a low risk situation to foreign investment, but present a single major vulnerability.

Sources of information The interpretation of data leads to the creation of information, which in turn, can be analyzed. The analysis of this information leads to the creation and application of knowledge. More time is often spent on the use and classification of information, and not much spent on collecting and sifting through irrelevant information. True, one needs to work through a large amount of sources in order to find useful information, but still, even the best method of analysis cannot produce fair forecasts if the information is dated, lacking, inaccurate, inapplicable or unreliable.

Political risk analysis necessitates a careful regard of the issues that are relevant to the organization, considering potential foreign investment opportunities, as

opposed to spending resources on irrelevant information. The decision makers in these firms are not always clear on the industry-specific issues of the host country's business environment that need to be analyzed.

The choice of "tool" for the political risk analysis should also be made with care. A generic model of political risk analysis can assist in cross-country comparisons for instance, but should be adaptable to suit a specific client's needs in an attempt to assess industry-specific micro risks within the macro environment. This also greatly contributes to the validity and accuracy of the analysis result.

The experience of country experts or specialists also becomes clear, yet their political perspectives must, as far as possible, not come into play, and their own style and skills should be of an objective nature. Still, no political risk analyst is completely and ideally objective, so the criterion should be the ability to be systematic in considering all the factors relating to a political assessment and the clear presentation of the data and information (Marks, 1986).

Predicting, forecasting, forewarning or anticipating political risk

Some authors contend that modeling for political risk analysis should not be about predicting, but about forecasting (Ascher and Overholt, 1985; Blair and Romano, 1988; Brod, 1992; Bunge, 1998; Grunberg, 1986; Jones, 1986; Reaves, 1992; Rehm and Gadenne, 1990; Simon, 1985; Zarnowitz and Lambros, 1987). Although it will form the basis of this part of the discussion, the terms "anticipating" or "forewarning"¹¹ are preferably used in this book. Nevertheless, the political risk analyst cannot (and should not) predict that risk will occur, or when it will happen, but can attempt to *anticipate a probability* upon observing certain trends or current events, and the way in which they come together.

There are elements to the analytical process that prevent the *prediction* of specific events.¹² A political risk model cannot predict when risk will occur, because, as Coplin and O'Leary (1994) explain, a number of elements of the analytical method and model prevent precise prediction. One is the model itself. Those who design models select different risk factors as representatives of the situations that they believe will precede possible harm to an investor. Social systems are notably complex, and reflective estimates of social attributes are used in any model. The projection of outcomes from a given situation can only be probable, because a model necessarily simulates and abbreviates a complex set of circumstances. The selection of representative variables and their relationships may not always result in the best possible projection.

The interchangeable use of the terms "forecast" and "predict" in political risk analysis sets a dangerous trap. A forecast presents an *estimate* of something in the future, a *probability* that a certain country *might* pose a *certain* degree of political risk to a foreign investor. Forecasts differ from predictions in the sense that a prediction foretells a kind of prophecy, and involves making statements about what events *will* occur in the future. A prediction seems more definite, where a forecast on the other hand, includes a probability factor and is based on sound rational

foundations, empirical evidence, scientific theory and formal procedures that include the process of systematic information gathering. A prediction results in a definite "yes" or "no" answer, whereas a forecast can be identified by the use of terms like "if...then" or "might" and "possible".

The complexity of social phenomena should never be underestimated (Bradley and Scheafer, 1998; Bunge, 1998; Coplin and O'Leary, 1994). Even with the best of models, the intention of being able to anticipate risk or enabling an early warning instrument will still be affected by factors that are not included in the design. There is always the possibility that some unforeseen event outside the scope of the analysis factors will affect the risk processes that result in losses. A flash flood could cause great damage to crops, followed by food riots and the replacement of a democratic government with an authoritative one that imposes strict controls on multinational businesses that deal in food products. Although the prediction of such an event is not quite possible, and the probability that it would happen not very high, the results of such an event does have political ramifications in society that may or may not pose a certain political risk to foreign investment in a certain host country. Contingency planning, should such possibilities arise, can be conducted in scenario developing exercises, in manipulating the weighed factor indicators in the presented model, or in a political risk policy as put forward in Chapter 6.

Additional reasons for choosing to rather use the terms "anticipate" or "forewarn" lies in a further element that prevents prediction, that of partial information. Even if an optimal model is used, the information that is applied at the core of the assessment and forecast is inevitably incomplete and possibly even inaccurate. Besides, investors may still choose not to follow political risk forecasts.

Still, accurate forecasts are difficult to make. Political attitudes are often shallow and more sensitive to comparatively minor disturbances or politically irrelevant factors, like a political executive's voice, dress, or private life. Political systems are often unstable, either internally, or because of external pressures. This is why many risk analysts prefer to use scenarios.

Apart from carefully acquiring the relevant information for political risk analysis, it is just as important to recognize the types of countries one will be dealing with.

'Country types'

It is necessary to distinguish the principle country "types". If countries can be placed in categories, it becomes possible to compare them with each other in a more meaningful way, thus gauging the level and types of political risk one country might pose in relation to another. Of course, no country is ever categorically only of one certain type. Care should be taken, for instance, not to simply "blacklist" certain countries in prejudice of their being "non-western". One should always bear in mind that the relativity of these country types may further

modify or evolve along the background of an ever-changing and dynamic world system, yet it is possible to group countries according to the way they relate to one another. Not only developing countries or emerging markets pose heightened levels of political risks (Bilson, Brailsford and Hooper, 2002; Furber, 1990; Silbey, 2001). Political risk factors are present in highly industrialized countries as well, be it in the form of unfavourable trade regulations, varying degrees of xenophobia, environmental degradation, amendments to industry specific standards or even intra-governmental instability and (institutionalized) corruption.

Calverly (1985) as well as Evans and Newnham (1992) categorize countries into advanced industrialized countries, newly industrialized or industrializing countries, primary commodity exporting or developing countries, and the dated terminology of former east bloc countries currently under the process of economic restructuring. Further country grouping include countries that are emerging markets, like those of Mexico, Russia, China, Venezuela, Chile and Brazil; and also countries undergoing political transition. It is contended that this classification or typification should be applied with caution though, exactly because of the danger one faces in committing the levels of analysis fallacies that will be discussed in greater detail later in this chapter.

Parameter specification Based on the discussion of country types above, and before a comparison of methodologies takes place in Chapter 3, it becomes necessary to address the issue of parameter specification due to the adaptable nature of the generic model offered in Chapter 5 of this book. As mentioned before, the model presented in this book is compiled from various political risk factors and their indicators, and is also designed to be flexible in the sense that it can be applied to a variety of contexts. This in itself can create a problem for the precision of measurement the model claims to be able to offer.

The problem lies therein that a set of assumptions underlies the chosen political risk factors and the values that are attributed to them – and these assumptions are not necessarily applicable in the same way in different contexts.¹³ The underlying assumption that also guides the weights that can be attributed to each risk factor in the model, is that consolidated liberal democracies pose less (or lower levels of) political risk. Investors would then, because they are rational decision makers, in all probability avoid investment climates with high levels of instability and /or corruption.

Yet this assumption is not necessarily true, which is why the generic model is adaptable and flexible, enabling its use in a variety of different contexts once the specific parameters of the particular investment climate has been established in consultation with either a client or a host government. To illustrate, foreign investors are aware of “organized chaos” and might even manipulate this due to their rent-seeking behaviour and the opportunities that can be found in “chaotic yet organized” investment climates.¹⁴ Still, one can apply an adapted, context-specific version of the model in Chapter 5 to enable guided and better-motivated decision making. Based on the generic model, one of the contentions of this book is that a

contextual analysis can be whittled down for any investment climate, and that parameters can be specified for any such climate when the need for such a political risk analysis arises.

Problem Solving Theory – A Theoretical Grounding

If the interest to invest exists, yet a client is uncertain of the best option, various possibilities can be analyzed and compared by means of political risk analysis as a way of managing such uncertainty. The application of management science can be viewed as a rational attempt at problem solving, bearing in mind that such “problems” do not exist in a vacuum, but relate externally to the explicit decision making environment as well as internally to individuals’ understanding of reality.

In all decision making processes, Bunge (1998; Beroggi, 1999; Chicken, 1986) explains, rational agents behave as risk-averse persons intent on minimizing uncertainty with the help of expert knowledge. It follows that, if unable to reduce these uncertainties to below some acceptable risk level, the rational agent will refrain from acting, or the foreign investor will refrain from continuing a particular foreign expansion project. Complementing problem solving theory, decision theory is generally assumed to be a theory underlying rational decision making under uncertainty. The major steps of decision analysis are defining the decision statement amongst uncertainty, establishing and evaluating objectives, generating alternatives, and finally comparing and choosing among options (Altier, 1999; Jennings and Wattam, 1998). Uncertainty may derive from limited knowledge or from the objectively random nature of the process occurring in or around the decision making environment in question (Beroggi, 1999; Bunge, 1998; Rapoport, 1983). In order to reduce these uncertainties, Chicken (1986) suggests taking the steps involved in decision making, which are conceptualizing the idea to invest or expand operations, conduct a feasibility study of the possible outcomes, prepare detailed specification, implementation of the decision, and eventual operation of the preliminary concept.

A political risk analysis, once conducted, draws the decision maker’s attention to the various problems that political risks might pose to the profitability of the investment. An awareness of the problems is created, and certain management steps can be taken in order to avoid or profit from them. Yet due to the dynamic nature of political risk(s), problems of political risk do not remain solved after analysis. But they can be monitored by constant application, adaptation and revision of the political risk analysis mechanism or model (Brightman, 1980; Lane, DiStefano and Maznevski, 2000; McCaskey, 1991).

In problem solving, potential solutions require a consecutive ordering of ideas that can be tested. It becomes clear that solving the problem of “where to invest” requires observations in order to find potential solutions.

As the words “problem” and “solving” denote, political risk analysis is concerned with situations in which one or more choices must be made, often under

conditions of uncertainty and risk (Beroggi, 1999). If a foreign investor's future "desired state of affairs" is a successful, profitable multinational corporation with possible subsidiaries in many different host countries, the investor is presented with the problem of how to attain this future scenario, and faces the difficulty of getting from one state of affairs (still in home country) to another (expanding to many host countries). Kaufman (1991) explains that this difficulty is a result of comparing the existing situation with a future imagined state of affairs that constitutes a desirable goal for problem solving. Kaufman (1991) reiterates the above by explaining that a problem is a discrepancy between an existing situation and a desired state of affairs. It is the intent of this book to address this discrepancy, to bridge the gap between the current and desired states of affairs, and to offer a means of arriving at the desired future state of affairs – that is, successful foreign investment by avoiding or managing political risks as risks to the attainment and profitability of foreign investment.

Changes in the political climate of a host country can result in risks that might impact negatively on a foreign operation's viability and profitability. It is imperative to constantly monitor the investment climate in which a foreign organization is operating for signs of such changes, by measuring and assessing the elements or factors of potential risk not only individually, but also in combination and in terms of their influences on one another. The emphasis of this explanation is on changes in a host country's investment climate, and the evaluation of investment options that eventually lead to actions that improve firm profitability. As mentioned above, the relationship between problem solving and decision theory is symbiotic. Where political risk analysis is a first step in decision making regarding foreign investment optimization, political risk assessment focuses on problems that call for decisions concerning the implementation of actions (investment), and in a way, deals with decision problems (Altier, 1999; Beroggi, 1999).

Such a decision problem can be resolved by the selection of appropriate actions, like investing now or in three years, for up to ten years, in a certain host country; not invest at all, or rather invest in one country and avoid another. However, the host countries under investigation, specifically their investment climates, change continually to a larger or lesser degree. This process of continual change calls for new decisions, and the fact that the effects of actions can run their course is crucial from a practical point of view and has to be kept in mind by political risk analysts and decision makers. An action might resolve one problem while creating others, requiring the continuous monitoring of a host country's investment climate (Altier, 1999; Beroggi, 1999; Jennings and Wattam, 1998).

To enable the political risk analyst to identify potential actions and to select the best course of action for a specific foreign investment project, the analyst must gain an in-depth understanding of the host country's investment climate as well as the needs of the investor; the elements present in the host country and their reciprocal impacts; and the effect they might have on the foreign investment. The analysis of potential political risks within a specific host country is done by

collecting data and information and processing them into a meaningful “picture” of the elements and their relations in the host country (Altier, 1999; Beroggi, 1999).

In problem solving, if the required investment climate or environment is known to the client, the analyst (by using the model presented in this book) can almost work “backwards” to find the conditions thought to make up the ideal investment circumstances (Brightman, 1980). The risk factor indicators can thus be weighed to explore and identify the ideal “weight”. They should then, as a result, reflect the identified ideal investment climate. In this way the “ideal host country” can also be sought and found.

A problem has no single answer that is definitely known to be correct, or for that matter, even incorrect. At the centre of a problem is an issue that inevitably needs to be addressed, like the question of whether or where to invest or not, which seems fairly unambiguous and relatively straightforward, but rarely has a single correct answer. Regardless of the way in which the question is construed, the core issue remains the same, namely that of whether, when and where to invest (Brightman, 1980; Pidd, 1996).

By defining the question and thoroughly qualifying it, or in this case narrowing the investment question down to a specific industry within a specific country (maybe even specifying the time frame and tenure), the answer to the core question will be very different from a vague “whether, when and where” question. In the case of political risk analysis though, any solved investment problem will remain solved for only a certain period of time – until a change in the national executive, for instance.¹⁵

Schön (1982) argues that successful problem solving practitioners strive to do two things. They try to relate new experiences to their existing past experiences, and also often try to maintain the uniqueness of the current situation. The current situation may well be interpreted based on prior experience or knowledge, yet the good professional does not simply apply a standard response but tries to keep in mind what is different and special about the current circumstances (Brightman, 1980; Pidd, 1996).

The conceptualization of “models” as such and the motivations for designing and ultimately using the model for political risk analysis as presented in this book is explained and discussed in great detail in the next chapter. Still, because Chapter 2 deals with conceptualizing the terms used throughout this book, it is important to introduce the term model and the idea of model designing in the following section in order to explain what a model is, as well as what its uses are.

A Model for Political Risk Analysis?

This book assumes that some critical issue is being faced that requires a decision to be taken or some control to be exercised. A decision needs to be made when an individual, a group, or an organization faces a choice in which there is more than one single option. To which country should we expand our operations? What kind

of investment should we make? What are the risks that can inhibit project profitability? For how long should the investment be made? For how long should the plans be shelved? What are the chances that an investment will fail due to which risk factors? The model for political risk analysis proposed in this book is offered as an alternative method that will hopefully contribute to easing the process of making decisions under complex circumstances of uncertainty and risk.

'Model': A conceptualization of the term

A model offers a way of applying rational analysis to complex issues. One of the aims and purposes of this book is to demonstrate how a model can be useful in helping to manage complexity in order to reduce the risk of making and implementing unsuitable decisions (Bradley and Schaeffer, 1998; Brightman, 1980; Carley, 1981; Jennings and Wattam, 1998; Pidd, 1996). The model in this book can act as a tool to support and extend the power of thinking, and has been kept as simple as possible, in the sense that a complicated model that is poorly employed may have worse consequences than a more simple model used as a tool for careful thought.

A model designed for use as a tool for political risk analysis can be conceptualized as *an extended representation of a certain potential host country's political and overall business and investment climate as viewed by potential foreign investors, political risk analysts and host governments, that wish to use the model for political risk analysis in order to better understand and comprehend, adapt to, manage and control the identified political risk factors the model is specifically designed for to deal with.*

This definition addresses the question of why a certain situation necessitates designing a model, as well as model purpose. These are crucial questions to ask when designing a model, for if a model is a simplification of reality, such a simplification should be done with an idea of the intended use of the model – in this case, for the purpose of making a decision regarding the question of whether to invest in a certain host country.

The model presented in this book aims to assist decision makers in making better decisions and to exercise better control over their responsibilities. In management science, models are often built to enable a manager to exercise better control or to help people understand a complicated situation. This does not necessarily imply that the model presented in this book is solely and exclusively reserved for use by only the managers in a decision making process. It does depend though, on the nature of the decision making process employed by different organizations.

As the conceptualization of the term model progresses, mention has often been made of the term "reality". Subjectivity was mentioned in the first chapter, implying that each individual using the model will have a different idea of what his or her reality should constitute during a decision making process. Each individual's reality is made up of past experiences as well as an idea of what the

future outcome of a decision should encompass, but a single model cannot possibly envelope each individual's own ideas of what "reality" should constitute. Individuals experience these realities with a set of internal assumptions that form their fields of reference. The model presented in this book helps decision makers navigate through various complexities of the decision making process. The problem of investing under threat of various political risks does not exist in a vacuum but in people's minds, and relate to their expectations and experience of the(ir) world.

By conducting a political risk analysis, one is already managing the political risks that might impact negatively on foreign investment. By studying and understanding all the (political) risks involved, one is able to change or adapt investment decisions by continually monitoring the impact identified risks might have on an investment – thus managing and controlling the influence these risks might have on consequential losses in profitability.

Although models aim to ease complex decision making processes by representing reality, merely defining a model as a simplification of reality would be an underestimation of the intent of modelling. It is these approximations of reality that make a model useful. The question that should be asked though, in anticipation of criticisms against models being a(n) (over)simplification of reality, relates to the degree of simplification that is sensible – bearing in mind that the word "reality" represents that part of the real world that is being modelled. In this case, the complex environment surrounding and infusing the decision making process of foreign investment. Doyle (1992 in Pidd, 1996) explains how models should be developed that are as simple as possible and yet are valid and useful for their intended purpose.

The point of a model is to *make explicit or concrete that aspect of reality that is being investigated* – the reality of foreign investment decisions. Inferred from the above discussion, the task of the political risk modeller is to take *ill-defined and implicit views of reality and cast them in some form well enough defined to be at least understood and argued over by other people* (Bradley and Schaefer, 1998; Jennings and Wattam, 1998). Although management is not only about decision making and control, one cannot negate the fact that these do make up a large part of management tasks and responsibilities. It is hoped that the model presented in this book can make a useful contribution to these two management aspects.

Still, regardless of the type of model in use, it remains important to evaluate a model in order to confirm and ensure that it constantly remains suitable for the purpose for which it was initially designed. This process is often called model assessment or model validation, and includes testing a designed model, and constantly monitoring its design and structure to measure its reliability and validity.

Investment Simulation and Interactive Modelling

The simulation of a political and investment risk analysis should be used because it is cheaper, safer, quicker and more secure than making a foreign investment without exploration, and learning with hindsight that an immense amount of money could have been saved if the investment scenario was played out on a computer-assisted model first. By applying the model, it becomes possible to establish whether a certain investment possibility will “work” or not without actually having to make the investment. Yet models designed for routine cases can be applied in exceptional situations for which they are not designed, and in which they do not function well. Good models may thus be used for the wrong situation, and in the process, wrong and often costly decisions can be made.

Although this book takes heed of such warnings, one cannot foresee everything and this book concedes that there will always be some events it will not be able to anticipate, but one can make the best use of the risk factors identified in this book in order to map possible probabilities, enabling in turn the ability to measure and anticipate such probabilities.

In using this model that is subjected to known inputs, the effects of these inputs on the analysis are noticed in the results. Based on the above discussion of political and country risk, as well as of the analysis of risk, it becomes all the more clear that the inter-disciplinary nature of political risk makes the consequent analysis thereof suitable to model simulation – political risk and the analysis thereof is dynamic, interactive and complicated (Bradley and Schaefer, 1998; Jacoby and Kowa, 1980; Jeffries, 1986; Jennings and Wattam, 1998; Kleijnen and Van Groenendael, 1992; Law and Kelton, 1991; Pidd, 1996).

Any investment environment is influenced by political risks that display distinctive behaviour known to vary through time. These political risk factors or phenomena are interactive. The investment environment consists of a number of political risks that interact with one another, producing the distinctive behaviour of the specific investment climate. The combination of these factors will inevitably vary, and these interactions will be observable, thus producing measurable risk.

At this stage of the discussion, after having clarified the main concepts the book will be dealing with, it is necessary to start addressing the possible methodological and theoretical problems encountered in political risk analysis and risk modelling.

Possible Theoretical and Methodological Problems in Political Risk Analysis

Much has been contested regarding theoretical and methodological difficulties encountered in the process of designing and building a model for political risk analysis, especially where the results of such an analysis are expected to be a valid reflection of political risk. Political risk analysis is a tool that is of incredible value to any organization or firm interested in pursuing profitable projects in foreign

countries. Yet the theories and methodologies behind the process of risk analysis are often lacking. A model for political risk analysis, after all, can only be as good as its components.

Problems with data, aggregates and model validation

Pidd (1996, p.108, supported by Bradley and Schaefer, 1998; Carley, 1981; Marks, 1986) makes the important assertion that "...[j]ust because data is available it should not be assumed that it is useful." This rings very true, and the discussion on the levels of analysis problems should follow on some thoughts surrounding problems encountered during analysis and modelling, due to the nature of data and the means of collecting it, as the levels of analysis pertain to the types of data used as well as the various levels from which data is gauged.

Certain validation errors can occur in model building, contributing to the various theoretical and methodological problems one might face in designing a model for political risk analysis and management. Linked to the mentioned problems of data analysis and (mis)use, is the reliability of data (Johnson and Joslyn, 1995; Neuman, 2000). Probably also valid as a limitation to this book, is the levels of analysis notion that it is often not possible nor even desirable to test a complete population about which information is to be gauged. One often needs to make inferences about a population by examining a sample of items from that population. Most members of populations vary somewhat and it might be necessary to estimate a statistic of some kind.

The difficulty in this is that no single sample size as an aggregation of a population can possibly contain all the information about that population's top and bottom quintiles. Data vital to its interpretation into information can be masked and consequently remain undetected. Inferences can be made from samples and may, in the light of full and complete information, turn out to be wrong. Depending on the nature of data collected for a country comparison for example, the sources of data must also be taken into account, so too the quality and age of data. In summary, the sample comparison has to be a fair one. The problems entailed in using aggregate data will be addressed further in a following section (Balci, 1994; Checkland, 1995; Checkland and Scholes, 1990; Déry, Landry and Banville, 1993; Gass, 1996; Law and Kelton, 1991; Oral and Kettani, 1993; Pidd, 1996; Roy, 1993; Schruben, 1980; Willemain, 1995).

A fundamental point that must not be missed is that the model should drive the data, and not *vice versa*. This means that the analyst should first try to develop some ideas of the model and its parameters, and then think about the type of data that might be needed (Bradley and Schaefer, 1998; Carley, 1981; Pidd, 1996). Data must be researched, requested, justified and collected before it can be interpreted. Still, the development of a model should not be dictated or limited by the availability of data.

Despite the above warnings being posted for the use of data, it would be wrong to imply that modelling is best carried out in an abstract way – data should not be ignored.

If the amount of political risk a foreign investor might face is clearly so significant that the weighing of the first few risk factors negates the possibility of even managing these risks, a preliminary analysis of not even the entire model might suffice in this regard.

Pidd (1996) asserts that an old adage among management information systems professionals is that *information is data plus interpretation* or $\text{information} = \text{data} + \text{interpretation}$. There is no substitute for proper and well-organized data collection if a useful model is to be constructed. It may also be possible to take existing data and “rework” it in such a way as to account for some of its shortcomings. Model testing can also illuminate discrepancies that exist in the data, which can be taken into account during the modelling revision process (Bradley and Schaefer, 1998; Carley, 1981; Pidd, 1996).

In the vast majority of cases, data is just a sample of what could be used or might be available. This is true in a number of dimensions (Bradley and Schaefer, 1998; Carley, 1981; Pidd, 1996). In terms of the time dimension, when data is being used to build or to test a model, that data would have been collected at a particular time and over a certain period. Yet due to the dynamic nature of politics and its socio-economic as well as socio-political ramifications, it is a contention of this book that a political risk analysis presented as an in-depth country analysis should be revised and re-evaluated on a regular basis – every month, for instance. This way, complacency with a seemingly stable situation can be avoided (Chicken, 1996).

The ageing of data is extremely important to monitor, especially if the results of a political risk analysis based on a model designed for a specific purpose is used to extrapolate into the future. Data is also a set of observations, and any observation process is subject to errors of different types. Such errors include recording errors, as well as transcription and analysis errors, where true meaning can get lost in translation. This might explain why data can be handled with a certain measure of skepticism – even if it is readily available.

The levels of analysis

In seeking to describe, explain and forecast the activities of a potential host country, one would identify risk factors from various levels of analysis, these being the psychological or individual level (i.e. the executive and the separation of powers), social or group level (i.e. ethnic, racial, national, social tensions), national or state level (i.e. economic policy), interstate level (i.e. foreign policy), and global level (i.e. trade policy) (Brummersted, 1988). Although these levels of analysis will be dealt with in more detail later in the book, it is worth mentioning at this stage that the “ecological fallacy” and “individualistic fallacy” are levels of analysis problems that should be avoided. The levels of analysis are also discussed

as the context within which they operate evolves, and a less rigid vertical application of the levels seems to be developing. Still, by using the units of analysis embedded in the levels of analysis cautiously, valid and trustworthy cross-country comparisons can be possible.

Kobrin (1981) explains how the broad range of political risk agents an organization faces that arise from the political and economic environment of the host country in which a foreign business wishes to operate, can be classified along two dimensions. The first classification encompasses political risks pertaining to macro risks in the broader environment, and the second to the industry specific micro risks that may affect the physical foreign ownership of invested assets. In its broadest sense, macro risks are those risks that will affect *all businesses* in a specific country, where micro risks will only impact upon a *certain industry*, and not on others at all (Venter, 1997).

Upon selecting types of risk factors for political risk analysis, factors and their indicators are usually amalgamated from various levels. As illustrated above, macro and micro risk factors are selected from different analytical levels.

The individual or psychological component is made up of factors that relate to the persona, beliefs, attitudes, past experiences and social background factors of political executives, and decision and policy makers (Neuman, 2000). This tends to be conceptually slightly elusive but justifies serious consideration in cross-national studies of host country behaviour as policy formulation depends to a large extent on the persona of policy makers (Bradley and Schaefer, 1998; Bunge, 1998; Masland, 2002). Brummersted (1988) uses the effect of leader charisma on foreign policy as an example of human behavioural influences on political risk, which can also influence investment legislation. A charismatic leader might be nationalistic but cognitively unsophisticated. Such a leader can play an influential role in foreign policy and investment policy making without prior training in conducting foreign affairs. Brummersted (1988) explains that the foreign policy of such a leader's government is usually unfriendly toward states outside its geographic region, being more assertive in its foreign relations in working to advance the country's role in seeking a place in the world order.

The political element should include variables relating to the political operation of a state in the context of the political system within which it operates. Examples may range from the nature of the relation between the legislature and the executive, party competition, as well as institutional and other group activities that may amount to governmental or societal political risk. In this instance economic factors also gain relevance, like economic performance and growth rate, inflation rates, and the balance of payments. Internal conflict and policy stability are also important in this regard, especially to the functionality and consistent profitability of foreign-owned enterprises in host countries.

If the individual, group and statal factors may be viewed as internal factors of political risk, the interstate and global components would be external in nature. Within the interstate components are risk factors that reflect external events to which a state must react by formulating policy, or to which social forces within a

state may respond in some way. Interstate trade relations, currency markets, and regional alliances or pacts are units of the interstate level of political risk analysis.

The global component of political risk analysis consists of all international systemic factors that may affect governmental and societal behaviour. Indicators thereof would point toward geographic position and geo-politics, systemic status-rank, and the level of systemic conflict that might influence a host country's stance toward foreign direct investment.

These different levels of analysis are accommodated in this book's model by the way in which the political risk factors are operationalized. Each identified political risk factor, be it economic, social or political, has its own set of indicators that may or may not literally "indicate" levels of the risk factor present in a certain country. Giving a risk factor indicator a relatively high rating would indicate the presence of a relatively high level of political risk pertaining to the specific risk factor, whereas a relatively low rating of such risk factor indicators would point toward relatively low levels of that political risk factor perceived to be present in a country. It is thus important to bear in mind that observations made on an individual level should not be generalized, just as observations made on a larger global scale should not be attributed to an individual level of analysis (Alvesson and Sköldbberg, 2000; Bradley and Schaefer, 1998; Bunge, 1998; Lazarsfeld, 1966).

Analysts should also be aware of the problem of ethnocentrism, and take care not to fall into its trap (Bradley and Schaefer, 1998; Bunge, 1998). One can easily, albeit unconsciously, interpret events from a "western-bias", comparing other political systems as second to western-style polyarchies. It is often the case that political risk forecasts reflect an element of normative advice to non-western countries of how a political system "should actually be run", negating specificities that warrant unprejudiced assessment.

The point that is being made is that political risk factors and their indicators should be operationalized in such a way as to not exceed the level of analysis from which they are taken. As mentioned before, the sourcing of information for political risk analysis is very important, and should be done with care. Aged and incorrect data will naturally impact negatively on the outcome of an analysis, resulting in ill-advised decisions and possibly great financial loss to foreign investment. The more reliable the information is, the greater the degree of accuracy becomes that can be achieved in political risk analysis. Marks (1988) reiterates this point when they explain that the essence of greater accuracy in assessing political risks lies in access to the latest and best possible information.

Ecological and individualistic fallacies Briefly touched upon in the preceding section and mentioned in the previous chapter, the "levels of analysis problems" pertains to ecological and individualistic fallacies that may come to the fore when conducting a political risk analysis. During the process of modelling, two further pitfalls must be avoided, namely over-simplification and over-elaboration, which are also discussed in the following section.

The *ecological fallacy* is easier to understand, and thus easier to avoid, if one

steers clear of “over generalizing”. The ecological fallacy is committed when an observation that is made at the general level (over a large population) is taken and applied to every individual within that population, that is, if data from the broad ecological level is taken and applied to an individual case. It would be false to assume that all developing countries or emerging economies pose high-risk investment environments. This is not necessarily true, as there are developing countries that pose medium or even low risk investment environments. An ecological fallacy involves taking a valid observation or generalization made on the aggregate level, and assuming that it would always apply to every case on the individual level (De Vaus, 2001; Johnson and Joslyn, 1995; Mahler, 2000; Neuman, 2000).

The reverse of the ecological fallacy is called the *individualistic fallacy*, occurring when an individual level observation is made, and incorrectly generalized to the aggregate level (Mahler, 2000). The individualistic fallacy will be committed if one accepts that, because the Coega Industrial Development Zone and harbour project might pose a relatively high risk to investors, all investment opportunities in South Africa might pose a high risk (Brink, 2001).

This book contends that one should proceed with caution and not hinder the validity and reliability of the end result by falling into the levels of analysis trap. The importance of this problem is at least recognized by an awareness that observations made on a certain level of analysis are really only safely used on that level. Despite this, it happens fairly often in all realms of social science research that one has to use data from one level in order to learn about another – researchers often have to rely on *aggregate data*, as is the case in measuring the level of social development in a country for instance (Bradley and Schaeffer, 1998; Carley, 1981; Hammersley, 1993; Marks, 1986; Snider, 1986). By measuring education and health care, only aggregate data is available in the average number of years of education, or the average number of hospital beds. Still, conclusions drawn from one level of analysis or observation must be used very carefully on another level, and the use thereof must be qualified sufficiently.

The danger of “over assuming” must also be avoided. Two political systems might have the same names, but perform completely different functions. Also, the same structure might have different functions in different political systems. For example, the South African lower house (National Assembly) plays a significant role in the election and appointment of the South African President...but the American lower house (House of Representatives) does not play the same role in the election and appointment of the American Executive (Mahler, 2000).

Over-simplification and over-elaboration The dangers of over-simplification during modelling present themselves in many ways. Pidd (1996) explains how a model designer often attempts to tackle one aspect of a problem situation in complete isolation from other aspects that may be equally or more important. In a political risk analysis there are many aspects to the problem of political risks that could be tackled, and most of them are interrelated – ignoring the linkages may

have undesirable effects on other aspects of the problem. The danger of premature or over-enthusiastic decomposition is that the resolution of one issue may worsen another aspect (Checkland, 1981).

Another way in which over-simplification may occur is due to the natural tendency to see what one prefers to see, for it is very easy to be bound by frames of which one is not even aware. Upon approaching a new situation, past experiences are also brought into play. Remedies might be applied that fit well with an individual's own expertise, and one might do this while ignoring other aspects (Pidd, 1996). This risk is almost inevitable, especially if it is true that what constitutes a problem is socially and psychologically defined.

In addition to over-simplification is the danger of over-elaboration or over-complication (Checkland, 1981; Pidd, 1996). As established in the preceding discussions regarding political risks and the analysis and management thereof by using a specially designed model, the complexities that make up the investment environment are interconnected both internally and externally. But where does one draw the boundaries around what is being attempted? Must a political risk analysis for a certain client in a certain industry within a certain host country be comparative in nature, and should it assess the political risk prospects of similar countries over the next 20 years?

The above questions probably depend on the system being studied and also on further questions that need to be answered. It may be true that the complexities of the political risk environment are interrelated in some way, but there is no doubt that some connections between political risk factors are stronger and more important than others. If the analysis is intended to merely have a short-term impact (say the investment is a "quick in-and-out" type maximum profit venture), then operating with a basic application of the risk analysis model may suffice. There is a hierarchy of dangers or risk factors in an investment environment – some of these risk factors only impact on an investment (depending on type, tenure and industry) after a certain period of time and in certain relation to one another. This is also why the identification of trends is an important function of this book's model. If occurrences of political unrest are mostly centred around elections, "getting in" or investing after one election and "pulling out" or divesting before the next can be profitable. This of course largely depends on the type of industry, investment and investor. However, things are hardly ever that simple.

The Reality and Reliability of Political Risk Analyses

Political risk analysts are also concerned with forewarning, or anticipating potential political risk possibilities arising from political and investment environments. The impact of such political risks varies across firms and projects, as the ability of a business to cope with political risks depends on the interaction and coexistence of political environmental factors, and the risk management strategy and structure of the foreign organization functioning within this

environment. This book maintains that not only is it important to conduct thorough viability studies and political risk analyses, but the contribution of such assessments to political risk management strategy and planning is invaluable. Apart from good political risk analysis, this book also aims to assist in coping with and managing political risk within a host environment in an attempt to foresee and prevent politically risky situations from impeding on firm profitability.

Still, in order to assess or analyze the potential impact of political or economic events on an organization, one must also be familiar with the nature of the particular host country's political environment. It then becomes possible to relate a specific detailed report on how the potential political, macro economic, societal, environmental and socio-economic climates of a host country are likely to affect a project.

Existing risk rating methodologies are limited and include mostly macro economic risk factors, measures of social structure and development, and political events that are primarily indicators of instability and/or regime change. The unit of analysis is almost always the nation-state, and there are related problems of reliability, accuracy, validity and comparability (Stubbs and Underhill, 1994; Kobrin, 1981). What is needed is a way of conducting industry specific (type, size, structure, experience with foreign expansion), time specific (short, medium or longer term ventures), and also investment climate specific political risk analyses.

It is vital to acquire knowledge of the political processes within a host country, and country specific expertise contributes greatly to political risk analysis. Of further importance is thorough knowledge of the prospective business itself, its structure and dynamics, technological position, strategic management policies, marketing policies, as well as its financial assets and liabilities. But even before a political risk analysis can be done, there is a problem which requires awareness, namely that of communication between the country and industry specialists – if and where these specialists are used in conjunction with the political risk analyst. A translation is required of the background, function, outlook, and differences between country and industry specialists. Ideally, these differences should be addressed and bridged prior to the preliminary political risk assessment. These, if not resolved, will surely impact heavily on subsequent risk management exercises, delaying consensus and wasting time in which profits could have been made, or in which a project could have worked at establishing itself in the host environment of which it endeavours to be a future part.

As mentioned in the first chapter, one obstacle to the systematic study of political risk is the inter-disciplinary nature of the subject. Both Simon (1982) and Kobrin (1981) note how difficult it often is for experts from various fields of discipline to communicate with each other about information relating to valuable political risk assessments, probably because their respective training and current interests produce different ways of looking at and approaching a problem, and one can see how difficult it may become to reach a consensual agreement on various points of interest. Still, the power of a good theory lies in its ability to explain various situations in different contexts, as this book shall attempt to illustrate by

means of applying problem solving and decision theory to risk management strategies, methods and suggestions. In this way the inter-disciplinary nature of political risk analysis, if all inputs can be harmonized, can in fact add to the validity and overall quality of an eventual analysis.

Political risk analysts face a further problem – that of attempting to conceptually model the processes through which political economic environments actually affect projects. Determining the nature of potential constraints is also a large part of the analytical problem, as is the forecast of the probability of their occurrence. Additionally there is a great deal of uncertainty about the nature of the relationship between the host country's political environment and the nature of the international firm investing in that specific country. Political risk analyses remain uncertain in the sense that they experience difficulty in specifying the set of outcomes that may result from a given event, and attempt to assign probabilities to these. Making this possible is one of the challenges of this book.

Another factor hampering the growth of theory in political risk analysis is the problem of time and financial pressure that companies experience, thus favouring sporadic individual country studies over systematic cross-national analyses. Conceptual frameworks as such are hardly ever developed to aid in the analysis of often expensive data.

A crucial and tentative step towards explaining various situations in different contexts, is to identify who the key actors are and to determine how their interactions can affect the formation and potential threat of political risk (Simon, 1982). According to Simon (1982), preliminary efforts and explanations must be broad enough to account for a multitude of actors, situations and environments that can affect the level and nature of political risk in certain countries. MNCs are exposed to a number of political risks that originate from a variety of sources. By identifying these key actors, and the manner in which their interactions can result in various kinds of risk situations in different types of countries, the political risk analyst can aid in isolating the early warning signs of stress factors which may causally evolve into factors of political risk.

One weakness of a structural analysis of political risk, such as a model, is that it tends to become static. This weakness can only be overcome, as this book will show, by maintaining constant awareness that social patterns are continually evolving as they interact. That is why the model presented in Chapter 5 is adaptable and flexible – enabling the political risk analyst, together with a potential investor, to add or subtract risk factor indicators or adjust the weights of factor indicators. Of utmost importance is an understanding of the dynamics of social change, how power is won and lost, how consensus and conflict are created or destroyed, and how norms and values may change, sometimes gradually, at other times suddenly. A political risk model should also try to avoid the natural analytical tendency to present institutions as being more “regular and predictable” in their functioning than they really are.

In the analysis of social actions and reactions, risk analysts should strive to forecast the relative strength of the groups that would play a role in the host

government's policy arena, the positions they would most likely take, and the probable outcome or influence this might have on the safety and the profitability of foreign investments in a country.¹⁶ The counter reaction of government is also of importance, because protest will bring about either a hardening or a modification of state policy, which in turn might be detrimental to the future sustainable activities of foreign organizations (Moody's Investor Service in Coplin and O'Leary 1994).

It thus becomes clear that the structures of social interaction are very important in risk analysis. The risk assessment process should include a wide-ranging analysis of the basic patterns of social interaction that characterize society within a country. This may involve using a variety of the traditional concepts like class, status hierarchy, and interest groups, but it is also important to understand and grasp the lines of conflict that run through a society. Some examples of these are the distribution of income and wealth; religious, ethnic or linguistic differences; conflict over lifestyle and ethical norms; or ideological splits reflected in struggles for control of institutions, including the state itself. Fundamentally, a model for political risk analysis should try to understand all attempts to create or mobilize power, in whatever form it may occur.

Concluding Remarks

This chapter dealt with the conceptualization of the most important concepts used throughout the book, and attempted to establish the theoretical base of political risk analysis. Terms explored in greater detail in this chapter all referred to the practice of political risk analysis as such, and an attempt was made to gain greater conceptual clarity on the definitive meaning of *political risk* and the *analysis* thereof. The terms "country risk" and "political risk"; "problem solving theory"; the process of "analysis" as such; "model" and "modelling"; as well as "predicting" and "forecasting" were all addressed.

The second chapter also attempted to further clarify some of the methodological and theoretical problems get encountered in political risk analysis. Although the limitations faced during the process of research conducted for this book were mentioned in Chapter 1, further limitations were touched upon in the second chapter, where the specific contexts of these limitations found a more fitting "place" in the book.

In Chapter 3, some risk rating methodologies are compared. The chapter also presents and discusses some findings in the light of the Asian Financial Crisis (AFC), and elaborates on the notion that macro-type models did not send off any "warning signals". It discusses some of the political undertones that were evident prior to the crisis, and that became clearer in its aftermath. The crisis is also revisited from a political risk analysis perspective, and mentions some lessons political risk analysts can learn from the Asian contagion.

Notes

- 1 Although briefly touched upon in this chapter, Chapter 3 will offer a more in-depth conceptualization of the terms “model” and “modelling”.
- 2 “Define” *vt.* – state contents or meaning, show clearly the form or outline, lay down clearly, mark out (Collins English Dictionary, 1993).
- 3 Private consultation with Albert Venter, 14 October 2002.
- 4 The effects may be minimal initially, but the impact can have future consequences. The interruption of business can damage public confidence and the failure to foresee potential dangers to assets can result in declining share prices.
- 5 Political instability can be used as a factor of political risk. Instability (a property of the macro environment) can, but does not necessarily always, cause or result in risk (for specific industries).
- 6 In 1990 there were only ten reported kidnappings in Malaysia but by the mid-1990s more than 100 a year were reported. This might be underestimated – many of the primarily Chinese victims keep their trauma to themselves, due to fear of the authorities, social embarrassment, or anxiety about repeating the experience. Given the existing evidence of possible army and/or police involvement in kidnap gangs, such reticence is understandable. The investment climate in the Philippines was dampened by the announcement that a trade delegation of Singaporean businessmen had just cancelled a trip to a trade and investments mission organized by the Philippine-Singapore Business Council. Their decision came in the wake of front-page stories in Manila newspapers that Singaporeans are now major kidnap targets. Similarly, media reports of Chinese businessmen and executives abducted by “kidnap-for-ransom gangs” have scared a group of Taiwanese businessmen who were en route to be at a conference organized by the Taiwan-Philippines Business Council. In Colombia in 2002, there were 1,500 known victims of kidnapping (<http://www.americasnet.net>). Also see http://www.pbs.org/newshour/bb/latin_america/latin_america.html.
- 7 On 14 February 2002, CNN reported that Hindu protesters marched to the Indian Houses of Parliament in protest against the “westernization of Hindu culture”. Valentines Day cards and related paraphernalia were set alight in demonstration.
- 8 Chapter 1 explained how political risk analysis draws information from a variety of disciplines.
- 9 In 1994-1995, the “Tequila crisis” hit Argentina and Brazil. In 1997-1998, the Czech Republic, Indonesia, Malaysia, the Philippines, South Korea and Thailand experienced both a banking as well as a currency crisis (Calvo and Mendoza, 1996; Cantor and Packer, 1996; Goldstein, Kaminsky and Reinhart, 2000).
- 10 Although import substitution is a mechanism used in making trade policy, the degree of protectionism rises in cases where host governments subsidize such import substitution practices.
- 11 The term “predicting” has too much of a definite finality connoted to it. One is left with the impression that, once a prediction has been made, there is no flexibility left in the assessment. Even with the best of models, variables that are not included in the design will still have some effect on the given situation and will reduce the possibility of “perfect prediction”.
- 12 The projection though, is that given a history, “usually” or “there is a high probability that” history will repeat itself. Or, given a set of certain current circumstances, a certain outcome has a high probability of following.
- 13 Private consultation with Philip Nel, 14 October 2002.

- 14 Reno (1999) points out that American investors are interested in the high returns of the Angolan or Nigerian oil industry, or the manufacturing industry in China for example, exactly because investors have developed the ability to exploit bureaucratic ineffectiveness in cooperation with officials (see also Chabal, 1999, *"Africa Works: Political Disorder as Instrument"*). This might raise ethical questions regarding the socio-political conduct of foreign investors, but the point remains that risk assertive investors will often exploit risky situations for higher returns.
- 15 The model for political risk analysis can be seen as the equivalent of a virus scan – by running a "check" every now and then, "flashing" indicators of political risk can be identified and further action can be taken in the management of these risks.
- 16 Reactions might range from a mere grumbling, laxity in implementation, the undermining of activities, to organized protest, electoral upheaval, or armed efforts to topple the regime in power.

Chapter 3

Thoughts and Examples on Modelling Political Risk Analysis

Introduction

Chapter 2 explained some of the theoretical and methodological problems that one might come across when conducting political risk analysis. In an increasingly complex and interconnected world, it becomes all the more vital to explore ways in which the consequences of decisions can be investigated *before* action is taken.

The model presented in this book is a simplification, an abstraction of features that are deemed important. If used sensibly, this model and its approach provide a way of managing risks and uncertainty regarding foreign investment by identifying risk factors and creating an awareness of their existence.

However, because a model is a simplification of reality there will always be something missing from the final application regardless of how many times it is planned and redesigned. The near impossibility of including every single risk factor that could impact on the profitability of a foreign investment remains a limitation. Even if a model is valid for the task at hand, there may be elements missing from it – implying that analyses based thereupon can safely be disregarded. The model presented in this book incorporates the consequences expected to follow from certain actions or factors (Beroggi, 1999; Pidd, 1996; Simon, 1976).

The way in which this book plans to develop explicit specifications of causal relationships and systematic analytical procedures, is by means of designing a model as a representation of reality; by offering a set of assumptions that are applied to enable the study of a particular phenomenon; and by testing the coexistence of various indicators of a phenomenon – in this case the levels and nature of political risk present in a given country¹ (Brodbeck (ed.), 1968; Kuper, 1987; Outhwaite, 1987; Rosenberg, 1988; Sayer, 1984).

In the following section, the complexities of modelling in social science is introduced, as well as the contentious issue of using mathematics to enable calculations based on measurements of qualitative “soft” variables. Some reputable rating methodologies will be compared. Primarily credit rating methodologies, some do include a few political risk factors, and are thus often deemed sufficient analyses of political risk as well.

The reason for comparing these rating methodologies is to show how a model for political risk analysis (that includes risk factors of economic, social and political nature) can be designed to enable a more comprehensive analysis of

investment climates. As credit ratings are often used unknowingly as an overall reflection of such climates, this book suggests that its model for analysis perhaps be used in *conjunction* with existing methodologies, financial and other viability studies, or be incorporated into future risk analysis methodologies.

This chapter motivates the need for the type of model offered in this book. One way in which its application can be gauged is by revisiting the Asian Financial Crisis (AFC) from a political risk perspective. As the discussion will show, it can be contended that the contagion could have been less severe had credit rating agencies been able to recognise the signs of a looming crisis. The question has to be asked – why were the credit rating agencies not able to assist in forecasting the crisis? The possibility that the methodologies of the ratings are slightly flawed has to be investigated based on the hypothesis that, had they been measuring with the right kind of “yardstick” or “tools”, they might have been able to pick up on the advent of a financial crisis that spread across the regional cluster to eventually settle far beyond East Asia.

An Evolution of the Mathematical

Kuper (1987) explains that mathematics is a powerful, flexible language and that models are representations framed in mathematical terms. Social science is mostly of a qualitative nature, and mathematics quantitative – at first glance it would seem that the two (social science, of which political risk analysis is a multi-discipline, and mathematics) cannot be reconciled with one another. But Arrow (in Brodbeck (ed.), 1968, p.636) is of the opinion that “...it is simply not true that mathematics is useful *only* in quantitative analysis”. An understanding of a community (which will either benefit from foreign investment or hedge against it) requires knowledge of its religious and social beliefs, and also involves knowledge of the distribution of income, the proportion of government resources devoted to societal needs, and even the population size and growth rate in relation to rates of (un)employment. These can then become indicators of possible occurrences of political risk.

In designing a model for political risk analysis as presented in this book, an attempt is made to show how the quantitative nature of mathematics in fact *assists* the qualitative measurement of social phenomena by contextualizing and operationalising useful qualitative variables.

Upon examining a given set of qualitative variables, individual social scientists might evaluate the relationships between these variables differently, and conclude with contradicting results. The same social scientist might not even come up with the same results twice. But in natural sciences, figures and facts are not open to individual interpretation in the sense of trying to establish the cause-and-effect relation between numbers. This book, aware of the natural science-social science debate, maintains that the two are not necessarily mutually exclusive, and that quantitative and qualitative measurements can be reconciled.

Although the model presented in this book is designed to be quantitative in nature, it does not intend to depreciate the value of other modelling approaches,

and is aware of how other methods can also be used in ways to assist an organization in making decisions regarding the viability of foreign investment.

In combination with a mathematical calculation, and the fine tuning or tailoring of a model for specific client needs regarding an industry or sector within a host country, the model in this book presents itself as a decision-theoretic application that hopefully compares well with existing methodologies.

Apart from enabling a political risk analysis, the model also aims to offer a way in which to manage these risks. In addition, the model can be seen as a mechanism for measuring an MNCs performance in a host country which can be fed back to and compared with the initial target level of performance – in this case, a level of profitability reached within a certain time, concomitant to political risk factors that might impede negatively on this set target (Davies, 1994; Pidd, 1996).

In cases where such feedback is negative, the differences between the target performance level (state of affairs) and the actual desired level of performance (desired state of affairs) can be used to guide the investment back toward its envisaged profitability. In light of an earlier discussion on problem solving theory and on data and reliable information, management systems depend to a great extent on the availability and quality of information about the investment climate that is fed back to the decision maker, who in turn is able to compare it with what is wanted and then adapt the investment criteria accordingly. In this way, the effects that political risks might possibly have on an investment are managed, and the aims of the investment, namely profitability, are closer to being realized. In doing this, decision makers can use the model presented in this book as a measure of what is likely to happen if certain action is taken, or if certain events occur.

Scenarios

Although the type of model presented in this book enables mathematical calculations and is based on problem solving theory and decision theory, the following section does warrant a discussion of another type of model used in management science, where the *management* of political risk is a goal of political risk analysis. The value of models and modelling approaches extends beyond the realm of only mathematical models. The use of scenarios in political risk analysis as an anticipatory tool is of great value. Any of the risk factors presented in this model can be used as variables, drivers or events during a scenario building exercise.

Scenarios are qualitative in nature, and are a well-known and widely accepted method of identifying key political and economic risks as well as opportunities. They allow for the constant comparative analysis of risks and opportunities and offer an overarching framework for organized political risk assessment.

Per definition, scenario planning is a further response to a perceived increase in uncertainty regarding the evolution of the general economic and political environments within which a company must operate (Ingram, 1993; Oxford Analytica Consultancy and Research, 1997; Schoemaker, 1993; Rossiter, Karplus and Jones, 1986). Scenarios are not predictions per se, but highlight possible

events and can provide a framework for the study of alternative futures. These instruments of risk modelling are outlines, and when used in strategic planning, seek to map changes, to identify "key branching points" of the future, and to highlight the major determinants that might cause one future to evolve rather than another. Scenarios are not exhaustive descriptions of all possible outcomes, but focus attention on the logical dynamics and interaction of unfolding events. In this regard, they can be seen as "tools" for organizing perceptions about future environments in which a foreign investment decision might be deployed.

May (1996) and Rossiter, Karplus and Jones (1986) share common themes in suggesting ways of preparing scenarios. The major procedural steps in the preparation of scenarios include the central concerns of the users of the scenarios; identifying the factors that are likely to have the most important influences on these central concerns in the future; analysing the important factors; assessing the importance and the uncertainty of these factors for the central concerns; selecting the scenario logics, the main theme or assumptions around which the scenarios are to be constructed; developing the scenarios, usually in the form of narratives that present a plausible sequence of events; analysing the impact of the scenarios on the key concerns with which the process began; analysing the implications for policy; and identifying the indicators that will help monitor changes as they occur.

Rossiter, Karplus and Jones (1986) go further to offer a perspective on general sequential method(s) that can be adopted to develop scenarios covering an MNC's business-specific concerns within a host country's investment environment in which levels of political risks are present, be they relatively low or high. These include listing the MNCs business-specific concerns; selecting the key influences, or factors, in the general operating environment which will determine the outcome of the business issues identified; projecting three plausible and internally consistent outcomes for each factor; combining the factor's outcomes and scenarios; and projecting outcomes for each business issue most appropriate to the scenarios.

To further explain the abovementioned steps in scenario building, the following section will describe the process in more detail.

Preparing a scenario

Firstly, the *listing of business issues* should be as specific as possible. For a MNC with one major product or interest in a country, a list comprising less than ten issues should be sufficient. For a manufacturing company, a list of business issues might include labour relations, wage costs, export requirements, exchange controls and local buying and hiring requirements. For an oil company, such a list might include the depletion of a resource and licensing policies, the actions of the state owned enterprise, gas flaring requirements, environmental legislation and the security of personnel (Ingram, 1993; Oxford Analytica Consultancy and Research, 1997; Schoemaker, 1993; Rossiter, Karplus and Jones, 1986).

By *selecting the key influences*, the determinants that will largely dictate how the operating issues of concern to a MNC will manifest themselves are identified. They are the scenario's independent variables and form the core around which a

scenario is created. They also enable the political risk analyst to make explicit possible assumptions, thereby facilitating agreement with the MNC on the likely outcome of the business issue in question and, where there is disagreement, encouraging the attainment of consensus. For example, an operational concern for a manufacturing company in a host country might be the degree to which it can repatriate its profits. The set of key influences shaping the issue would include the government's economic policy and its willingness/ability to stand by that policy (policy stability); the state of the balance of payments; the perceived need for foreign investment; and the host country's degree of exposure to retaliation. For an oil company, a concern would be the amount of oil production it must sell locally at below-world prices. Factors of this issue would include the government's level of commitment to free markets, the rate of growth in local oil consumption, the state of the balance of payments and the general state of the world oil market (Ingram, 1993; Oxford Analytica Consultancy and Research, 1997; Schoemaker, 1993; Rossiter, Karplus and Jones, 1986).

The *projection of factor outcomes* entails projecting two or three outcomes for each factor, thereby providing a range of possible futures. The more important the issue is to the MNC and the more uncertain the operating environment is, the wider this range should be. In scenario planning, simply pairing together all the optimistic and all the pessimistic outcomes should not establish the bounds for the factor's outcomes for the MNC. The result of such pairings will most likely produce implausible outcomes. As an example, high economic growth and rising oil prices may be an "optimistic" outcome for an oil company, but it runs counter to generally accepted economic theory (Ingram, 1993; Oxford Analytica Consultancy and Research, 1997; Schoemaker, 1993; Rossiter, Karplus and Jones, 1986).

Projecting outcomes for each factor necessarily produces a scenario and there is no discrete step in scenario development in which the factors are combined. Instead, this step acts as a convenient point for checking that the factor's outcomes provide a satisfactory range of possible futures and that they are both internally consistent and plausible (Ingram, 1993; Oxford Analytica Consultancy and Research, 1997; Schoemaker, 1993; Rossiter, Karplus and Jones, 1986).

The final step in scenario development is to *assess the implications of possible scenarios*. While this step is probably the most important as far as the MNC is concerned, it should be reasonably straightforward for the planner to execute. The scenario planner should find that a range of plausible futures for the MNC's business concerns flows smoothly through all the steps, thus providing a clear sense of what the MNC's opportunities and risks will likely be throughout the planning and implementation phases (Rossiter, Karplus and Jones, 1986). Scenarios as a management tool for political risk analysis are successful if they clarify the future; identify future problems; are relevant to the organization's current scope of activities; identify what needs to be changed; are credible and intelligent; developed without the involvement of the ultimate users; and if they are internally consistent and logical.

Still, strategic decision making remains complex, which is why a quantitative decision-analysis model is proposed as a tool for conducting political risk analysis

in an attempt to make sense of complexities.

In constructing a model or tool for political risk analysis, a model designer should be aware of his/her role as facilitator as well, and should not take for granted that the participants in the decision making process all share the same view about the reality of the investment process. The model designer should thus constantly consult with these decision makers and take into consideration the differing perceptions of those involved.

Strategic management literature suggests that, in decision making processes regarding foreign investment, differences in interpretation(s) are not unusual but rather commonplace. The model offered in this book lends itself toward a decision-theoretic model which allows for risk assessment, and is intended to be an objective measurement tool that can be used to help decision makers find enough consensus over issues to eventually agree on strategic action regarding foreign investment. Problem solving theory and decision theory are risk averse, and are assumed to be the more general theory underlying rational decision making under conditions of uncertainty.

Problematic Encounters During Model Designing

Certain business-industry-type constraints restrict the choice a political risk analyst and the client might have in deciding upon the most favourable investment destination, and share a common theme with the methodological and theoretical problems mentioned earlier in the second chapter.

Data problems

Information is expensive, and cost-cutting often takes place in an effort to save time and money with the result that the quality of data accuracy and reliability can be poor. Suitable data may not be available, as data is very rarely presented to the investor or risk analyst as such and often needs to be budgeted for in the prospective capital layout. Data must be researched and sought, collected, analyzed, validated, interpreted, paid for, and presented very carefully. Because data ages quickly, it is very important to bear in mind at every stage of the analysis process that data collected for a certain risk factor or purpose will not necessarily be suitable for another, especially when a time lapse occurs or trends are studied. Other examples can be operational costs within a host country, maintenance costs, exchange rates, rates and taxes, rent, and salaries. Awareness of this should prompt the investor and decision makers to negotiate a contract specifying that such prices be fixed on a profitability/percentage scale.

Regarding the decision to invest, most decisions have a finite life. It may be more important to select an option that appears to be robust rather than one that is immediately attractive but eventually turns out to be dangerous if circumstances change. This augments the necessity of constantly and vigorously monitoring and analysing an investment climate for signs of such possible changes.

Constrained choice and the induction trap: uncertainty or risk?

The multi-disciplined nature of political risk analysis assumes that making a decision to invest in a host country is not as simple as merely finding a foreign country with an investment climate conducive to maximizing expected returns. Political risk analysts advise clients about considering circumstances that unknowingly feature constrained choice (Pidd, 1996; Raiffa, 1968; Slovic, 1990; Watson and Buede, 1987).

Constrained choice implies the notion that circumstances exist in which, although there probably exists a straightforward and agreed upon decision criterion (maximize profit), there are other aspects to consider, like the political, economic and social factors of political risk within a host country. These aspects can impact on a foreign investment in such a way that the investor loses money, or does not make as much as anticipated when the decision to invest was made.

A way in which to manage these risks is to treat these aspects as constraints to profitability or viability that will be applied *before* the decision parameters are set. The basic idea is to assess all the options against the constraints by means of conducting a political risk analysis, or by creating scenarios. The best comparable investment option can be selected from a set of alternatives.

The problem of uncertainty is a major impediment in decision making and political risks, but can be countered at the epistemological level. While knowledge cannot be used to change the past in any concrete way(s), it is still essential for individuals to utilize past experiences in order to deal with the present as well as with the future. If understood as a cognitive problem, reasoned and defensible decisions in political risks have important implications.²

The first would be that justifications for decisions be available before investment decisions are taken; the knowledge for the purpose of justification is bedded in past experience that is always specific with regard to space and time. In contrast, future references require general statements that are not bound by spatial and temporal restrictions.

The second implication would be that, in order to deal with the present of the future, the justification for a claim whereby a decision is to be taken cannot be based on the logical relation between past experience and the content of the knowledge claim. Formal logic fails if one attempts to base the future on past experience in a logical way. Logic in and by itself does not overcome the problem of induction. The "induction trap" implies that past experience is logically no guarantee that the future will resemble the past.

A solution to the "problem" of knowledge or the "induction trap" can be offered by explaining that a pattern of relations, which may refer to observable or normative preferences, once established, is assumed to hold for a particular situation in the environment. Once that assumption is made, the implications of the pattern (which is a formal or a logical structure) can be transferred to the environment in order to produce the needed anticipation, control or choice. Experience gained by using the pattern provides grounds for training, rejecting or modifying the pattern before future use. Experience justifies the knowledge claim

contained in the pattern. The more the experience is tested against reality, the stronger the pattern is assumed to hold. Knowledge can evolve and be justified in the cycles of trial and error, application and observation of consequences that the ongoing human situation makes possible. Assuming that patterns created out of past experience will hold for the future circumvents the induction trap. To assume the opposite would be both contrary to human experience as well as self-defeating. In other words, by assuming that no patterns will hold and that the future is entirely unanticipatable is untenable.

Miller (1991) explains the extent to which uncertainty about environmental and organizational variables reduces the predictability of a firm's performance and thus increases risk. Uncertainty can be perceived as pertaining to the general environment or investment climate of a specific host country in which a foreign firm operates, where such uncertainties correspond to factors that affect the business context across industries. This refers to "macro-type" risks that are not firm or industry specific, but that impact upon all firms and industries within a host country. General environmental uncertainties that may develop into macro risks include political instability (war, revolution, coups, changes in government), government policy instability³ (fiscal and monetary reforms, price controls, trade restrictions, nationalisation, government regulation, barriers to profit repatriation, inadequate provision of public services), macroeconomic uncertainties (inflation, changes in relative prices, foreign exchange rates, interest rates, terms of trade), social uncertainties (changing social concerns, social unrest, riots, demonstrations, small-scale terrorism) and natural uncertainties (variations in rainfall, hurricanes, earthquakes, and other natural disasters) (Miller, 1991; Venter, 1999). Where these factors of uncertainty might pose a risk to foreign investors, the model proposed in this book as a tool for political risk analysis attempts to assist investors in identifying and managing these uncertainties.

Pidd (1996) bases the distinction he makes between risk and uncertainty on an idea that, unless probabilities can be objectively estimated, they should rather not be used. Most people accept that probabilities can be related to ideas of frequency for events that happen many times. Conditions of risk or uncertainty occur when one cannot know with absolute certainty that a particular choice will lead to a particular outcome. There may be no guarantee that any of the investment options analyzed by the political risk analyst and considered by the investor are certain. The possibility even exists that the investment might fail completely.

Some authors (Beroggi, 1999; Raiffa, 1968; Slovic, 1990; Watson and Buede, 1987) make a clear distinction between decisions taken under *uncertainty* and decisions taken under *risk*, although outcomes are non-deterministic in both cases. A *risky* situation would be one in which it was possible to know the probabilities of various events taking place, or the probability of certain political risks impacting on a foreign investment. An *uncertain* situation on the other hand, would be one in which these probabilities cannot be known at all. By operationalising qualitative observations, it is implied that at least *some* of the factors that may (or may not, for that matter) possibly impact negatively upon the profitability of a foreign investment can be known by identifying political risk factors and operationalising

them by attributing observable and measurable indicators to each political risk factor.

Still, as mentioned in the first chapter, human rationality has its limits,⁴ especially when operating under uncertain conditions (Bunge, 1998; Pidd, 1996; Simon, 1972). It is for this reason, among others, that an attempt has been made to design a model as a means of assisting decision makers to become aware of identified risks as such, and not merely operate blindly under conditions of uncertainty. In fact, uncertainty about political events (be they leadership succession issues, form(s) of government and/or state, government (in)ability), or rather political uncertainty about and within a host country, can actually be deemed a political risk factor in itself.

Limited rationality

Bunge (1998) explains that, when having to make a complex decision, rational agents behave as risk averse individuals intent on minimizing the impact risks might have on their foreign operations.

There is often considerable uncertainty about the consequences of various choices that might be made and there are a variety of reasons for this. Information about these consequences may not be available, and may have to be forecasted, extrapolated or modelled as a substitute for (un)available data (Neuman, 2000). In addition, it is not only the host country and its investment climate that can pose risk(s) to foreign investors, but even competing investors within the same identified industry or sector in a host country. A competitor's activities can also impact upon a prospective foreign investment, and it should not be assumed that the decision maker has complete information about all the viable options. The competitor might even have found more information, or discovered different means to acquire that information, or might even have engineered a way to modify investment conditions in order to create more options.

It seems that crafting a viable investment strategy and wise decision making requires the support of both expert intuition as well as rational analysis. The role of analysis, as used in political risk analysis, offers an exploration of the possible consequences of different courses of action that can be taken when making a decision to conduct foreign direct investment. Rational analytical approaches do not necessarily provide direction nor do they identify alternatives as such. Being able to predict with complete certainty that events will happen is a rarity indeed.

The usual reaction of the social scientist when confronted with a model for political risk analysis, is to assert that it is "oversimplified", that it "does not represent all the complexities of realities",⁵ and that it does not explain the occurrence of political risk (Arrow in Brodbeck (ed.), 1968; Brightman, 1980; Rosenberg, 1988). Of course, there are certain limitations in using quantitative models in social sciences, but the advantages are equally apparent.

The model presented in this book attempts to be as reflective of reality as possible, carefully constructed, user friendly, easy to understand, and by no means does it aim to result in laborious efforts to comprehend its workings. It

encompasses political, economic, environmental, societal and socio-economic political risk factors and their indicators. The user attributes a value or “score” to each indicator in the model when assessing the particular country or industry in question. The range of values is given to the user, as well as a “guide” as to what circumstances should score how many “points”. This model tries to quantify as far as possible, the mentioned risks that concern a company or any organization considering foreign expansion.

Comparing Selected Risk Rating Methodologies

Due to the mentioned limited scope of this book the number of risk ratings used in the following section has been limited to the eleven more prominent rating methodologies. Before setting out to design the model presented in Chapter 5, it was necessary to take a look at current risk rating methodologies and see how they compare. Many of the examples used in the following discussion are indeed purely credit or country risk ratings, and by no means profess to be political risk ratings. This might be exactly the point though – one of the challenges of this book is to see if it is possible to design a *comprehensive* and relatively easy to use tool for analysing political risk. The idea was to set out and design a model for analysing political risk as *investment risk* – a model that is reflective of the comprehensive business and investment climate in a country.

The methodologies that will be briefly analyzed in the following section are, according to Coplin and O’Leary (1994) and Howell (ed.) (1998), widely utilized risk rating methodologies (they are discussed in alphabetical order and are in no particular order of importance). Although some of the methodologies incorporate a few classic political risk factors, it is felt that the political risk factors included in these ratings can be expanded upon. The book does this in Chapter 4 and 5 after comparing the rating methodologies, explaining briefly how each rating methodology works, how many political risk factors are included (provided the methodology is not purely a credit rating tool), adaptability for industry-client specific micro analyses, how the results are calculated, and how the results of the analyses are presented (are they presented as letter grades, are they numeric, or descriptive, ie. high/low/good/bad).

Table 1 below summarizes 11 prominent risk rating methodologies, after which a description of each methodology follows. Although different methodologies are described, more than one of the methods is often employed by the same company. Although the rating methodologies differ in their design and approach, in almost every case, the operationalisation and rating or measurements of the factors lack transparency. Apart from International Country Risk Guide (ICRG), hardly any of the rating methodologies take social factors into account, negating their potential important contribution to political risk. Environmental issues, as indicators of a country’s economic prospects, also fall short of inclusion. The economic prospects of especially agri-economies, raw material exporters, single commodity exporters, and single crop economies can experience hazardous levels of climatic

vulnerability. Regarding the adaptability of the risk factors and their weights, ICRG and Political Risk Services (PRS) methodologies offer such flexibility. Institutional Investor (II) offers client participation in an indirect manner as bankers rate the banks under scrutiny, although not those of their own countries. Some methodologies do offer industry specific ratings as well.

Table 3.1 A comparison of selected risk rating methodologies

	Number of Countries Rated	Political Risk Factors Included	Kind of Rating	Industry specificity	Form	Frequency
BERI	50	10	Mostly credit	Yes	Index	3 per annum
CRG	118	3	Mostly credit	Yes	5 point Likert Scale	Daily (electronic)
Country Outlooks	80	None	Credit	No	Country Groupings	1 per annum
EIU	100+	22%	Mostly Credit	Yes	Letter Grades	4 per annum; monthly updates
Euro-money	180	25%	Mostly Credit	No	Letter Grades	-
II	135	None	Credit	No	0 (worst) to 100 (best)	2 per annum
ICRG	140	50%	Political Risk	Yes	Very Low to Very High	Monthly
Moody's	35	Some	Credit	No	Letter Grades	-
PRS	106	Yes	Political Risk	Yes	Letter Grades	Monthly updates; annual complete revision
S.J. Rundt	-	33.3%	Some Political Risk	No	1(best) to 10 (worst)	-
S&P	-	Willingness to pay	Credit	Yes	Letter Grades	-

Business Environment Risk Intelligence (BERI) S.A.

BERI offers proprietary services as well as multi-client services that include Quick Response, Country Risk Ratings for Exploration and Development of Natural Resources, and Industry-specific country briefings.

BERI provides a complete picture of country risk based on a set of quantitative

indices that have been developed and refined over a period of 25 years. A comprehensive Profit Opportunity Recommendation (POR) is an average of three ratings, each on a 100-point scale. The "R Factor" index is also a weighted index that covers a country's legal framework, foreign exchange, hard currency reserves, and foreign debt. The POR thus represents all aspects of country risk. Risk is calculated for the present, as well as one-year and five-year time frames. The Operations Risk Index (ORI) includes weighted ratings on 15 economic, financial, and structural variables. BERI also offers a Political Risk Index (PRI) composed of ratings on 10 political and social variables. BERI's Business Risk Service provides quantitative rankings on government proficiency, labour force evaluation, and market opportunity. Ratings are presented every four months with qualitative information and indices for 50 countries, with additional country coverage for selected indices (Coplin and O'Leary, 1994; Haner and Ewing, 1985; Howell (ed.), 1998; Venter, 1999; <http://www.beri.com>).

Control Risks Group (CRG)

Control Risks Group (CRG) provides macro level risk assessment in three focal areas, namely Political Risk, Security Risk, and Travel Risk. Each is rated on a 5-point Likert-type scale ranging from "Insignificant Risk" to "Extreme Risk". Political stability, economic stability and campaign issues are assessed under Political Risk, and Security Risk takes into account violent/terrorist groups, crime, and border conflict/border war. Travel Risk covers matters such as crime, the possibility of strikes, terrorism and war conditions. The CRG ratings cover 118 countries, and are accompanied by written assessments. CRG tailors its ratings and reports to enable micro level risk, that is, analysing the particular exposures of individual firms investing in specific circumstances (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.prsgroup.com>; <http://www.countrydata.com>; <http://www.crg.com>).

Country Outlooks

In its *Country Risk Monitor*, Bank of America World Information Services evaluates country risk on the basis of 10 economic ratios. An ordinal ranking is created for each of the ratios of 80 countries. A country with the least economic difficulty or problems is given a rank of 1, and a rank of 80 is associated with the most economic difficulty. A comprehensive ranking of the averages is then created to provide a picture of relative risk by *averaging* the ranks across the 10 variables. The *Country Risk Monitor* provides rankings for the current year, historical data for the previous years and projections for the next five years. Apart from being useful for investors in the financial and banking industries, the rankings can also serve as an indicator of stability for firms in other business sectors. Bank of America also provides a *Country Outlook* for each of the 80 countries covered, as well as the rankings and ratios for each of the 10 included variables (Coplin and O'Leary, 1998; Howell (ed.), 1998; <http://www.bankofamerica.com>).

Each country is ranked according to income per capita, governmental fiscal responsibility, involvement in international trade, strength of trade performance, size of foreign debt, and the country's capacity to pay foreign debt. A benchmark mechanism is also used, and countries are grouped into the categories of problem countries (countries whose international debt is under restructuring), non-problem countries, low income (under \$2500 per capita income), middle income (\$2500 - \$15000), high income (over \$15000), industrial countries, all developing countries, OPEC countries, non-OPEC (oil producing) developing countries, Asia, Latin America, the Middle East, and Africa (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.bankofamerica.com>).

Economist Intelligence Unit (EIU)

The Economist Intelligence Unit's (EIU) Country Risk Service assesses composite country risk for investors through four types of risk, namely Political Risk (22% of the composite), Economic Policy Risk (28%), Economic Structure Risk (27%), and Liquidity Risk (23%). The political risk component includes the two subcategories of *political stability* (represented in the five indicators of war, social unrest, orderly political transfer, politically motivated violence and international disputes) and *political effectiveness* (represented by the six indicators of change in government orientation, institutional effectiveness, bureaucracy, transparency/fairness, corruption and crime). Economic policy risk is determined by rating 27 variables in the five categories of monetary policy, fiscal policy, exchange rate policy, trade policy, and the regulatory environment. Economic structure risk incorporates global environment, growth, current account, debt and financial structure groupings in 28 variables, and liquidity risk covered by a further 10 variables. In each of the four categories, numerical scores are converted to letter grades ranging from A to E (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.theworldin.com>; <http://www.eiu.com>).

EIU also provides "specific investment risk" in the form of Currency Risk, Sovereign Debt Risk, and Banking Sector Risk. These are also rated on a 100-point scale and are converted to a letter grade. The CRS ratings are supplemented by extensive data and written assessments on each major category. The reports cover 100 countries on a quarterly basis, with updates on a monthly basis in the CRS Handbook (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.theworldin.com>; <http://www.eiu.com>).

Euromoney

This methodology provides qualitative assessments for each of the countries it covers and provides a full country risk rating based on nine individual variables. These include economic data (25%), political risk (25%), debt indicators (10%), debt in default or rescheduled (10%), credit ratings (10%), access to bank finance (5%), access to short-term finance (5%), access to capital markets (5%), and discount on forfeiting (5%). The total score is then scaled over 10 lettered categories (AAA to N/R). The Political Risk assessment is a single indicator

created on a 0-10 scale derived from country experts, brokers, and banking officers. It is specifically derived as a risk of non-payment or non-servicing payment for goods and services, loans, trade-related finance and dividends, and the non-repatriation of capital (sovereign risk), and is reported along with the full country risk index. Their reports also include a Corruption Perception Index, with data supplied by Transparency International (<http://www.euromoneyplc.com>; Coplin and O'Leary, 1994; Howell (ed.), 1998).

Institutional investor

Institutional Investor is a credit rating mechanism and addresses the single issue of "creditworthiness" in a 100-point index. Bi-annually, bankers from around the world are asked to rate more than 135 countries on a scale of 0 (very high chance of default) to 100 (least chance of default). The responses from more or less 100 banks are then weighted according to the worldwide exposure of the bank and the level of sophistication of the specific bank's analytical model, and the weighted average becomes the Institutional Investor's Credit Rating. The ratings are published in both worldwide and regional lists that indicate changes from the previous six months and one-year. Banks are not allowed to rate their own home countries (<http://www.institutionalinvestor.com>; Coplin and O'Leary, 1994; Howell (ed.), 1998).

International Country Risk Guide (ICRG)

This rating methodology provides a rating composed of 22 variables in three subcategories of risk namely political, financial and economic risk, with a separate index created for each subcategory. The Political Risk Index is based on 100 points, Financial Risk on 50 points, and Economic Risk on 50 points. The total points from all the indices are then divided by two in order to produce the weights for inclusion in the composite country risk score. The composite scores, ranging from 0 to 100, are then categorized between Very Low Risk (80-100 points) to Very High Risk (zero to 49.5 points) (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.icrgonline.com>).

The Political Risk Rating is composed of 12 weighted variables covering both political and social attributes and ICRG advises users on means of adapting both the data and the weights in order to focus the rating on the needs of the particular investing firm. Country reports include descriptive assessments and economic data. ICRG provides ratings for 140 countries on a monthly basis (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.icrgonline.com>).

Moody's investors services

Moody's provides a Sovereign Credit Risk Analysis that assesses the ability of countries to service their future obligations on foreign currency debt securities. While some of the variables analyzed might be useful in forecasting other forms of

risk, the credit risk rating derived by Moody's is explicitly focused on this one form of risk and should not be applied for an alternate exposure (Coplin and O'Leary, 1994; Howell (ed.), 1998; Nye, 1986; <http://www.moody.com>).

Moody's analysts assess both political and economic variables in establishing credit risk for both short- and long-term projections. In the political category, the degree and nature of political intrusiveness on the cultivation of wealth; depth and experience of government bureaucrats; political intrusiveness on economic management; political links with foreign partners; past behaviour under stress; and regime legitimacy are included. For economic fundamentals the nation's resources, resource exploitation, quality of national economic management, structural dependencies on export/import sectors, export mix, international capital flows and austerity programs are examined (Coplin and O'Leary, 1994; Howell (ed.), 1998:265; Nye, 1986:13-35; <http://www.moody.com>).

Moody's provides a pure sovereign credit risk analysis that assesses the ability of countries to repay or service foreign currency debt securities, and the rating mechanism is by no means a political risk rating (Coplin and O'Leary, 1994; Howell (ed.), 1998; Nye, 1986; <http://www.moody.com>).

Political Risk Services (PRS)

This methodology forecasts risks for investors in a two-stage process. A probability is assigned to the three regimes with the greatest likelihood of assuming power within 18-month and 5-year time frames. For each regime, PRS establishes the likely levels of political turmoil and of 11 types of intervention that affect the business climate. A consolidated source for all regimes is calculated and converted to a letter grade in three areas of investment, namely financial transfer, direct investment, and export markets. PRS also provides a means of adapting any forecast to the particular exposure of a firm. Variables may be added or omitted by the user, or re-weighted to fit industry or firm attributes (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.prsgroup.com>; <http://www.polrisk.com>).

PRS provides historical backgrounds, actor biographies, and forecast scenarios, as well as basic data on government structure and economic data. Reports for 106 countries are provided, with monthly updates and complete revisions on an annual basis (Coplin and O'Leary, 1994; Howell (ed.), 1998; Venter, 1999; <http://www.prsgroup.com>; <http://www.polrisk.com>).

S.J. Rundt and Associates, Inc.

S.J. Rundt and Associates provides a systematic evaluation of country risk based on three equally weighted composite indicators, namely Socio-Political Risk, Domestic Economic Risk, and External Accounts Risk. These composite indicators are averaged to create an overall country risk score (<http://www.rundtsintelligence.com>; Coplin and O'Leary, 1994; Howell (ed.), 1998).

Within each measure of risk, country specialists rate a set of variables on a 1-10 scale, with 1 representing the best circumstance and 10 the worst. The Socio-

Political Risk category assesses 12 variables, including stability of the government, social stability, and government intervention in the economy. In addition to the score assigned, each variable is given a weight signifying its contribution to overall Socio-Political Risk (<http://www.rundtsintelligence.com>; Coplin and O'Leary, 1994; Howell (ed.), 1998).

Domestic Economic Risk includes 16 variables, weighted as Socio-Political Risk and graded on a 1-10 scale. External Accounts Risk also includes 16 variables and is similarly scored (<http://www.rundtsintelligence.com>; Coplin and O'Leary, 1994; Howell (ed.), 1998).

Standard and Poor's Ratings Group

Standard and Poor's Ratings Group (S&P's) offers ratings in the seven major areas of long-term debt, commercial paper, preferred stock, certificates of deposit, money market funds, mutual bond funds and insurance companies' claims-paying ability. Ratings are based on the consideration of the likelihood of default, the nature and provisions of the debt obligation, and the protection afforded by, and relative position of, the obligation in the event of bankruptcy, reorganization, or other arrangements under the laws of bankruptcy and other laws affecting creditor's rights (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.spglobal.com>; Ruess and Beers, 1998).

The result of a S&P's rating is a forecast of debt-servicing capacity, incorporating Political Risk (sovereign risk as the *willingness* of a sovereign to repay debt on time) and Economic Risk (default risk as government's *ability* to repay its obligations) (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.standardandpoors.com>; Ruess and Beers, 1998).

Political Risk includes an analysis of the underlying (in)stability in a political system, the social environment and the international relations of a country. Economic risk evaluates the ability to repay obligations based on a country's external financial position, balance-of-payments flexibility, economic structure and growth, management of the economy, and economic prospects. S&P rates countries in each debt category with a triple letter rating system (AAA to D) reflecting least risk (AAA) to most risk (D) for an investor (Coplin and O'Leary, 1994; Howell (ed.), 1998; <http://www.spglobal.com>; Ruess and Beers, 1998).

It becomes clear (see Table 1) that very few of these rating methodologies offer comprehensive risk ratings. Granted, many of them are per definition country or credit risk rating methodologies, but few are flexible or adaptable to enable client-specific or industry micro-type analyses. Many use letter grades to indicate the rating of a country, which are problematic as such because the true increments of comparable ratings are not easily distinguished between, for instance AAa, Aaa and AAB, whereas the difference between, say, 65 per cent and 60 per cent probability that political risk might occur seems easier to interpret. The model presented in this book is also not rigid in the number or "type" of countries it can rate. It can be applied as a tool for the in-depth analysis of a single country, or to

conduct country comparisons. The weighted values of the political, economic and social factors can be adjusted, as well as those attributed to the risk factor indicators.

The following discussion will also further illustrate the need for a model like the one offered in this book, and the lessons learnt from the Asian Financial Crisis (AFC)⁶ are unfortunate but good examples of the scope for new research into political risk analysis, and for models that better reflect and better represent the comprehensive reality of different investment climates.

Revisiting the Asian Financial Crisis from a Political Risk Analysis Perspective

As the following discussion of the Asian Financial Crisis (AFC) aims to illustrate, the case for including political risk factors and their indicators in the risk assessment of countries as well as specific industries becomes stronger. The idea of a more comprehensive risk assessment model that incorporates political, social and economic (micro) risk factors attempts to address some of the lessons political risk analysts can learn from the impacts, repercussions and effects of the AFC.

The book dares to contend that, had at least some of the micro political factors and their indicators been used prior to the advent and ripening of the said crisis, its economic, political and social ramifications could have been better anticipated and to some extent minimized. As early as 1994, Paul Krugman offered some convincing arguments in anticipation of the AFC that will be expanded upon further in the following discussion.⁷ In a manner of speaking, the use of micro risk factors and their indicators as suggested in this book, could have possibly helped to “soften the blow” of the AFC.

Admittedly, the AFC was primarily a financial crisis, impacting upon banking and currency sectors throughout the affected areas. Still, the following discussion aims to further strengthen the case for a more comprehensive model of political risk analysis. This does not at all suggest that a political risk analysis model can be used to anticipate a financial crisis, but it can surely serve as an early warning system that might prompt financial analysts to subsequently look in other places, perhaps previously not thought of, for signs of possible danger. The model presented in this book attempts to combine country risk indicators with the admittedly overlooked micro indicators of political risk.

Political governance should be of great concern in risk analysis practices as the bottom-line of any policy, government action, or market sentiment. Deutsche Bank’s Kenneth Courtis illustrated this when he said that what is needed is to “constantly survey the world’s horizons, make policy changes to adjust – and have them adopted”, referring to stable policy flexibility and policy penetration (Bacani, 1997).⁸ This is but one of the functions the political risk analysis model in this book aims to perform, as certain questions were asked in retrospect of the Asian crisis. It is answers to these questions that are being investigated and will be addressed in this discussion, presented as risk factors in a methodological design for a political risk analysis model, or an “Early Warning System”. As the

discussion on the AFC develops, the application and operationalisation of political risk factors and their indicators will be offered as an illustration of how they can be applied.

The aftermath of the AFC is important to political risk analysts for a number of reasons, one of them being the major implications for the future development and investment prospects of the affected countries. There may be a major increase in bad loans and poverty levels in those countries, implying a major trend reversal from previously high levels of per capita income. This also affects the size of average disposable incomes and the size of markets for foreign investors. Of course, depending on the type of industry targeted, the mentioned ramifications might pose problems to a greater or lesser extent.

Although the implication for developing countries will be explored further as the discussion progresses, the above implies that the benefits of foreign direct investment in the long run are more advantageous to overall economic development than short-term capital solutions. Upon investigating a strategic “fit” for foreign investors, political risk analysis as part of planning and decision making becomes very important, as the following will show.

Toward the end of the 1990s, many authors have attempted to explain the AFC, and others have speculated on ways of preventing the same from happening elsewhere in the world (Bacani, 1997; Camdessus, 1997; Crisp, 2001; Goldstein, 1998; Goldstein, Kaminsky, and Reinhart, 2000; Griffith-Jones, Cailloux and Pfaffenzeller, 1998; Ople, 1999; IMF, 2000; Reisen, 1998; Reyes, 1998; Shameen, 1999 IMF, 2000). This book contends that the crisis was not purely financial in nature – with hindsight it becomes clear that it had a myriad of micro political and societal underpinnings (FitchIBCA, 1998; Luce, 1998; Ranis and Stewart, 1998; Saludo, 1997; Tesoro, 2000).

In the following section, the presence of risk factors that were not purely financial at the advent and in the aftermath of the AFC will be identified and explained, including political risk factors that were part of the undertone of the crisis’ contagion effect. Some thoughts are also offered on why such political risk indicators should be included in risk rating mechanisms as possible “early warning” instruments in future.

Evidence of risk factors not purely financial in nature

After reviewing some of the post-crisis literature, it becomes clear that Asian central bankers found it problematic to manage free floating currencies, and investors pulled out of companies dependent on imports and companies with large loans. Corporate bankruptcies were on the rise and government flaws and inabilities were being unearthed, implying economic planning failures, corruption and nepotism in government, the questionable quality of the bureaucracy, and a lack of political will and/or the ability to deal with these events.

Still, the extraordinary records in economic growth attained in East Asian Newly Industrialised Countries (NICs) had conventional analysts wondering about both economic policy and geopolitics. Literature on global economics prior to

1997 pointed toward three notions, one being the diffusion in world technological advances and that the East Asian NICs have long since surpassed Western countries in this regard. Secondly, it was thought that the global economic hub would shift away from the United States and Europe, and settle in East Asia. A minority of authors emphasized a third idea, being that the success achieved in Asian economics was in part attributed to economies planned in superiority of democratic and individual rights and freedoms (Crawford, 1995; Mauro, 1997; Piggot and Salmon, 1996; Reich, 1992). These observations raised questions regarding political systemization, the openness of political systems, issues of legitimacy, government behaviour, and the record or status of human rights.

To enable such a disciplined transformation process, the politics in East Asian NICs had to endure certain measures as well, limiting the liberation of, among other things, the market place (Crawford, 1995). Civil liberties and democratic individual rights were limited – societies accepted strong, often authoritarian governments and were willing to curb individual rights in the interest of the common good. Economic participation was guided, and immediate consumer rights were forsaken for long-term growth figures that would prove to eventually outperform those in Western societies.

In Krugman's (1994) article however,⁹ Kim and Lau (1994, p. 7) conclude that "the hypothesis that there has been no technical progress during the post-war period *cannot* be rejected for the four East Asian newly industrializing countries". Another author (Young in Krugman, 1994, p. 7) noted that "once one allows for their rapid growth of inputs, the *productivity performance* of the '[Asian] Tigers' falls from the heights of Olympus to the plains of Thessaly".

It seems that it was just a matter of time before an Asian growth ceiling was reached, and with certain contributing factors, shattered upon itself. With hindsight, growth rates were illustrative of an occurrence that could not have been sustained, and there were tremendous upward changes in figures that could not have been repeated. Once the inputs contributing to these astonishing growth rates were exploited, runaway progression seems to have left inexperienced policy and decision makers in its wake. The point is reiterated that "growth [could] be explained by increases in measured inputs. There [was] no sign at all of increased efficiency" (Krugman, 1994, p.6).

What Krugman (1994) also found very interesting, was that several of the East Asian tigers had become significant exporters of capital. The reason he found this odd, was because the exporting of capital apparently signified that these economies were rapidly achieving advanced-country productivity – despite the fact that these East Asian economies still paid their workers wages well below advanced country levels.

Despite his suspicions, even Krugman (1994) was cautious to overstate his case. He leaves one with a relatively open-ended argument, affirming that "barring a catastrophic political upheaval, it is likely that growth in East Asia will continue to outpace growth in the West for the next decade [1994 - 2004] and beyond" (Krugman, 1994, p.12). He does concede the point though, that the growth East Asia might experience up to 2010 will not be at the pace of the pre-1997 years.

One of the most disturbing aspects of the AFC, apart from not having been able to forecast it, was the fact that it started and festered in a region inclusive of the most successful developing countries during the thirty years prior to the meltdown. It was also deep and prolonged, and witness to a runaway contagion. It was the size and scope of the experienced crisis that literally shook the world and saw the bottom dropping out of equity markets as far as Brazil and Russia.¹⁰ Some degree of an AFC could probably not have been avoided, but circumstances leading to the advent of the crisis could have been anticipated much earlier, thus limiting the *magnitude and scope* of the eventual crisis, and perhaps even restricting the contagion somewhat (Cherian and Perotti, 2001).

Credit risk agencies and the Asian Financial Crisis

Reputable credit risk agencies were unable to make an accurate and timely forecast of events that witnessed the advent of the AFC in June 1997¹¹ (FitchIBCA, 1998; Luce, 1998; Tesoro, 2000).¹² Still, the reliance placed on ratings by investors and government as a substitute for an own risk assessment is alarming, given the relative limitations, often methodological, of credit ratings in comparison to the impact these results have on global markets.

Goldstein, Kaminsky and Reinhart (2000, p.49) assert that "...rating agencies should do better in predicting [even] currency and banking crises in developing countries (since financial crises are more closely linked to the probability of sovereign default there than in industrial countries)". They further challenge the notion that credit ratings should be expected to be leading indicators. Rating agencies receive fees from the borrowers they rate, and because downgrades can subject the agencies to charges of having precipitated a crisis, some argue that credit ratings are apt to behave as lagging indicators of crises, with downgrades coming only after credit crashes (Goldstein, Kaminsky and Reinhart, 2000).

In an on-going debate, it is argued that on the one hand credit rating agencies failed to forecast the AFC. On the other hand, it is argued that they were not equipped to do so, as most credit rating agencies provide assessments about the ability of foreign borrowers to repay loans and service future obligations on foreign currency debt. Although some of the variables provided in the methodology used by rating agencies include factors relating to the political system, it is still the contention of this book that some political risk factors were either overlooked and underestimated, or excluded from current risk rating models, and that they should be included in an improved model as an Early Warning System for future use.

Goldstein (1998:19) maintains that "...to judge from most market indicators of risk, private creditors and rating agencies were asleep prior to the outbreak of the [Asian] crisis." Suffice it to say that a more comprehensive indication of risk is needed. Sovereign ratings issued by Moody's and Standard and Poor's remained unchanged during the 18-month run-up to the crisis. The sovereign ratings issued by Euromoney and Institutional Investor did not perform well either. The same could be said for stand-alone credit ratings for some individual Asian banks (Radlet and Sachs, 1998; World Bank, 1998). Country risk agencies often expand

into a market without a tight grasp on the complexities involved, and without being fully aware of the impact of their ratings.

It becomes possible to present two alternative speculations as to why market signals did not produce warnings of a looming crisis much earlier, one being that creditors did not have accurate information on the creditworthiness of borrowers, pointing towards the problem of government transparency and reliability of information, as well as the previously-mentioned problems relating to the quality of data.¹³ The other speculation was that creditors expected governments to bail them out in case of trouble.

Of course, credit ratings are often used mistakenly as being reflections of political and social conditions in countries as well, apart from presenting a rating of a country's creditworthiness. Political and social risks are not shown in all instances, and a country with a high credit rating may mistakenly be perceived "safe" regarding political risk as well.

Still, in the case of the Asian crisis, the credit rating agencies were somewhat at fault by abruptly and dramatically lowering country ratings quite a while "after the fact". In this case it could be said that they fell short of monitoring creditworthiness and updating risk ratings. In their defense though, they also had to contend with a (lack of) available information, a "herding instinct" concomitant with market sentiment, and professional chance taking.

Yet one can expect the role that these agencies play to become even more important as the globalization of investment markets, improved technology and deregulation lead to greater freedom of investment and more widespread movement of capital flows (Asian Development Bank, 2001).

The main concern in the above discussion is that the existing rating methodologies were not able to "pick up" on the underlying and preceding micro political circumstances that surrounded and even contributed to the advent of the financial crisis. In the following section, a case will be made for the necessity of either including micro political risk factors and their various indicators in credit rating methodologies in future, or of using a model like the one offered in this book in conjunction with existing rating mechanisms in an attempt to prevent such a contagion from spreading again.

Lessons for Political Risk Analysis: The politics of the Asian Financial Crisis

Despite the financial nature of the AFC, it might be possible to prevent such future crises by including micro political risk factors and their indicators in rating methodologies as a type of "early warning" mechanism. Unfortunately only with hindsight does it become clear that there were political undertones present prior to and during the Asian Financial Crisis. Political leadership and governments in every country that contracted the effects of a spreading contagion experienced the consequences of the crisis. The following section examines some of the lessons that can be learned, and is revisited from the perspective of political risk analysis. The Asian crisis brought across many expensive yet invaluable lessons. One of these, as Goldstein (1998) explains, is the fact that in an atmosphere of political instability, consequential uncertainty about reform and wide-ranging contagion, the

overshooting of exchange rates and equity prices can be much larger than previously thought. It seems that this political instability was overlooked by credit rating agencies and by the managers of financial institutions. Goldstein (1998) asserts that there is nothing like a crisis to motivate a rethink of the adequacy of the existing crisis prevention/management architecture. It would seem that expensive lessons are quickest learnt.

Economically, the main factors contributing to rapid economic progress in East Asian countries included a free enterprise environment, export orientation, high levels of capital investment, the productive use of labour, and a large pool from which to pick and choose among managerially-skilled individuals. Contributing cultural or social factors to East Asian success seemed to be a co-operative relationship, a susceptibility to order, moral responsibility, strong family ties, a strong work ethic and a strong orientation toward entrepreneurship.

The link between economics and politics remains strong through fortunate and less fortunate times. Of course, political events result in certain economic decisions being made, in the same sense that economic events have certain political consequences. As the AFC spread and the contagion matured to include Northeast Asia, political repercussions were becoming evident and policy makers were facing the consequences of their actions. For example, the previous South Korean Finance Minister lost his office as a result of bad decision making, and a new South Korean Minister of Finance and Economy took office on 19 November 1997. Lim Chang Yuel took over from the ousted Minister of Finance and Economy Kang Kyong Shik, and all measures against the crisis that were prepared by the ousted politician were dropped due to his dismissal. These events raise individual level of analysis questions regarding confidence in the finance ministry, and leadership succession issues (Sprague and Nakarmi, 1997).

As in other countries strongly affected by the Asian crisis, South Korea had long-standing serious weaknesses in its financial sector and in the prudential oversight of banks. Much of this is linked to *government-directed* lending to large corporations or *chaebols* (Goldstein, 1998), large equity holdings by banks, lax accounting procedures, and a lack of transparency on the part of banks and corporations. Furthermore, the most important “chaebols”, heavily funded by the South Korean government, either posted losses in 1996 or declared bankruptcy.

With hindsight, post-crisis analysis shows that government inability on the part of all governments involved was also a culprit in the contagion – a micro risk or political risk factor that was overlooked. The rating agency FitchIBCA admitted that the notion of government inability should have been introduced as a factor worth measuring, and that government ability in these cases was greatly overestimated. It also “takes the blame” for not realizing that something was amiss, that, although the balance-of-payments and short term lending figures flashed no warning signals, the use of micro indicators or political risk indicators could have forewarned the rating agency. Planning and strategic management could have started in anticipation of a crisis, and if this could not have been avoided, the ramifications thereof could have been cushioned (FitchIBCA, 1998; Luce, 1998).

To further illustrate the position that the use of political risk factors can make a difference in a more comprehensive way, some comments by Goldstein (1998) and Griffith-Jones et. al. (1998) are used to strengthen the argument. Goldstein (1998:12) writes that “[t]here was excessive government ownership of, and/or government involvement in, banks. Banks often became the “quasi-fiscal” agents of governments, providing an oblique mechanism for channeling government assistance (off-budget) to ailing industries”.

The IMF World Economic Outlook (1997) also noted inadequacies in the prudential regulation and supervision of financial institutions as a major source of the financial systems weakness. The IMF added that limited experience among financial institutions in the pricing and managing of risk; lack of commercial orientation; poor corporate governance; and lax internal controls, all in the face of movements toward liberalization and increased competitive pressures, had contributed to imprudent lending including lending associated with relationship banking and corrupt practices.

With the exception of Singapore and Hong Kong, the amount of capital that banks had at their disposal could not cover the risks involved in the environment in which they operated. There was also a strong manifested expectation that depositors and creditors would get bailed out if these banks got into trouble. Evidently though, bank supervisors did not have the authority, or the mandate to counter strong political pressures for regulatory forcefulness. In addition to this, the quality of public disclosure and transparency was very poor (Goldstein, 1998; Griffith-Jones et. al., 1998 (Kim and Mei, 2001)).

It follows that a variety of political risks were at play here. One of these can be found in the evidence pertaining to the public's lack of access to information regarding the status of the institutions they banked with, and another points toward the issue of transparency. Varying degrees of information disclosure and institutional transparency – or lack thereof – can be measured as political risk factors. The less transparent institutions are and the less access the public has to information, the more weary an analyst should become of the possibility that political risk indicators might show themselves in heightened levels of the probability that risk might occur.

The role of government (in)ability in dealing with the crisis Questions regarding the reasons why governments were incapable of dealing with the onslaught of the crisis and the management thereof come to the fore. What factors, political and/or institutional, contributed to government inability or unreadiness? And how was fiscal (mis)management at fault?

A further political risk factor, which can be measured by political risk indicators as shown in this book, relates to the nature and size of the role that a government plays in the banking sector. In the case of the Asian crisis, it is evident that the larger the role a government plays in the banking sector, and the more far-reaching government interference or intervention is in the banking sector, the higher the probability of the occurrence of political risk might become. This, coupled with long-standing weaknesses in banking and financial supervision, saw a contributing risk factor present itself at the advent of the Asian crisis.

As the crisis ripened, the governments involved were not up to the task of dealing with the crisis or managing the devastating effects thereof. The contagion effect ascribed to the Asian crisis is grounded in the impact of globalization and economic inter-relatedness. Apart from the fact that the contagion spread across the Asian banking cluster, economies "removed" from this cluster were affected as well. Be it in banking or government authorities, policy and decision makers were unable to manage the ramifications of the effects the crisis had on poorly contrived policies manifested in economic planning failures, legitimacy issues, and government behaviour.

As fiscal discipline is also included in this book as a political risk factor, it seems fitting to comment on the alleged fiscal discipline practiced in these countries. Lenders had the confidence that, should local financial institutions encounter difficulties, the public sector (government) would have the resources to provide assistance. However, it did not, and here political risk comes into play.

Although some factors contributing to the Asian crisis were market related, policy reaction and policy penetration should still have been scrutinized. Literature suggests that the *quality* of the investment in these countries was less impressive than the *quantity*. Corporate governance was very poor and much of the private investment was directed toward over-ambitious infrastructure projects or inefficient government monopolies, relating to issues of the nationalisation of key industries/sectors, and the degree of protectionism (Bacani, 1997; Crisp, 2001; Crowell and Hamilton, 1998; Krugman, 1994; Ople, 1999; Reisen, 1998; Reyes, 1998; Saludo, 1997; Shameen, 1999; Sprague and Nakarmi, 1997; Tsang Yam-Kuen, 1999).

Challenges for post-crisis governments Notwithstanding its financial character, the Asian crisis presented the region's political leadership with challenges of a different kind. Despite the call for more openness and competitiveness in technological skills, "domestic openness" might contribute to regional recovery and prevention of future problems. This illustrates a call for more domestic transparency, modern legal frameworks, eliminating (the perception of) corruption, and the building of strong modern institutions founded in stable political institutions. Without strong, stable political institutions, economic modernization cannot be dealt with and the stress on the system overloads its capacity to deal with inputs (Mahler, 2000).

Regarding disabled governance that East Asia experienced during the crisis, the private sector cannot be held responsible for functions that surely pertain to the public sector. Social cohesion and public resource distribution, be it in health care or education, are responsibilities the private sector should not be held accountable for.

The importance of political will must not be underestimated either and is also a factor contributing to the measurement of political risk in this book. A lack of political will is decidedly negative, as opposed to a positive commitment by government and its "tools" as an expression of political will. Not only is constitutional and limited government a manifestation of political will, but so too is

responsible government – government making promises that it knows it will be able to keep, and policies that are truly in the public and national interest.

A primary challenge for governments in post-crisis Asia would be to provide stability and “balance”. A very important point for political risk analysts to bear in mind is that coupled with rapid economic growth is also heightened public expectation. As mentioned before, government has to equip itself with the ability to deal with both the quantity and quality of public inputs. Having political will also implies the legitimacy and authority to enforce carefully planned or “willful” policy.

Public popularity and responsible government are difficult to achieve simultaneously, and one does not pre-suppose the other. Responsible government, even with a popular mandate, usually has to deal with unpopular policies and demands, even if these are in the best national interest. Government effectiveness in appeasing public opinion and remaining responsible simultaneously is no mean feat. Maintaining domestic confidence among political succession, high levels of debt and fragile banks necessitates strong and grounded institutions manifested in high levels of political development.

The answer to the question of what drives market sentiment remains elusive. Definite contributing factors are political and macro economic speeches in which underlying executive sentiments and ideologies may spark market runs, as well as regime outputs or behaviour. The link between *the political* and *the economic* is a familiar one...but the days where governments were accountable *only* to the electorate are all but over. Governments are becoming increasingly accountable to market confidence as well. Inputs to the system are not only public anymore as markets also place demands on the political system. Governments are warned to check what they publicize in case the market gets driven downward, or market expectations become realities.

A further challenge faced by post-crisis political leadership would be the salvaging of public institutions. From the above discussion it becomes quite clear that only efficient and able public institutions can deal with system overloads (Mahler, 2000). The quality of the employees the public sector can attract, and the extent to which they are compensated, should be a departure point. Domestic “brain drains” from the public into the private sector have hampered the ability of institutions to deal with heightening demands and expectations. A slackening in the quality of any institutional infrastructures for public policy is disconcerting. Institution building requires patience and sustainability and is something that a government should be able to push on with over time. Ideally, public sector salaries should not only be competitive in order to attract qualified people, but also to *distract* public officials from the temptation of being corrupted, or of being corruptors.

Public confidence in the system also contributes to its legitimacy, and is nurtured and maintained through accountable, responsible and responsive government. Public institutions should act as an inclusive mechanism, making people feel part of the decision making process and in turn contributing further to the legitimacy of the political system. The distribution of labour between the public and private sector should also be clear – in other words, what the role and

responsibilities of the civil service and that of private sector activity should be. This can also contribute to the enriching of decision making in both these spheres, of a system of checks and balances; and the separation of powers of an autonomous and independent legislature, executive and judiciary.

Leadership quality plays an unmistakably big role in the management of the political system – a part of the broader environment in which markets and big business operate.

In terms of the relevance of this book and model, and in learning from the experiences of the AFC, Goldstein (1998) expands on further valuable lessons learnt. Notwithstanding the importance of including micro risk indicators in an improved Early Warning System based on the performance of credit rating agencies, there are other important issues to consider. Despite the financial relief that the IMF provided, the social ramifications of such packages have interesting relevance for political risk analysis, as socio-economic and societal factors are also included in the model presented in Chapter 5.

The social wake of the contagion

A useful point of departure for investigating the social impacts of IMF packages would be an overview of IMF actions that assisted contagion-struck countries to overcome their various crises. In this case, political risk literally comes into play. IMF packages often have strings attached, and the impacts of Structural Adjustment Programs (SAPs) have been documented in the past (Goldstein, 1998; Todaro, 1989). SAPs often have more adverse effects and consequences than the intended positive impact. Also, as Goldstein (1998) explains, the support provided by official financing is necessarily accompanied by policy changes and reforms. These changes are often not accepted or understood by those hardest hit in crisis situations – namely the public. As the impact of IMF reforms filter through, reactions might vary from civil uprisings to civil war and xenophobia as economic hardship becomes political and channeled against government.

One can wonder why the Asian countries waited so long for help from the IMF. The cost of IMF borrowing, inclusive of the costs of IMF conditions, is not very high in the sense of deterring sovereign borrowers from counting on the IMF as a safety net in case of an emergency. This might be a reason why “Asian crisis countries” saw the situation ripen to the point where the IMF stepped in. On the other hand, developing countries might enter into agreements with the IMF knowing that they have no intention of servicing these loans, or even the interest on them. Here the *willingness* to service loans comes into play, included as one of the political risk factors in this book.¹⁴

Due to the contraction of economic activity and the higher cost of living, ordinary citizens in the crisis countries needed to make more substantial sacrifices to overcome the crisis, not excluding the possibility that these citizens held government responsible for their increased financial burdens – especially if large domestic and foreign lenders escape their share of the burden. If government put up the funds for rescue packages, which were borrowed from the IMF, it is the

broad public that bears the brunt in the form of higher taxes to enable their government to service loans.

The importance of responsible and accountable government cannot be stressed enough in this regard. Fiscal tightening and the restructuring of supervisory laws regarding banks, corporations and other financial institutions is an important indicator of levels of political risk. But it is the (in)ability of government officials to make policy decisions based on these "safe" practices that heightens a risk situation.

The impact on the people experiencing the fall-out from the Asian financial crisis can by no means be disregarded or underestimated. Since the advent of the crisis, bankruptcies were mounting which directly translated into the loss of jobs. As economies stalled, investors pulled out of stock markets, banks were closed under the surmounting weight of bad loans, and depositors' savings were inaccessible for months.¹⁵

As an example of the possible political risk ramifications that investors might face, namely that of a social uprising and demonstrations, on 20 October 1997 a mostly middle-class crowd of approximately 4 000 protesters were outside Government House to witness the Thai Prime Minister accept *pro forma* resignation letters of 48 cabinet members. Protestors were demonstrating against job losses and wage cuts caused by the fall-out from the then still ripening crisis.

Southeast Asia enjoyed rapid growth during the boom years, but what is asked for now with hindsight is a drastically different kind of leadership. One that can push and enforce unpopular policies, resist vested interests, and survive public outrage and social uprising without quelling the spirit of such actions – a valuable part of public political participation and a sign of healthy political culture. This calls for a government that can be responsible even if unpopular, and be able to hedge against an onslaught on its legitimacy. The public, with tremendous socio-economic pressures, should *consent* to being governed by such institutions, and *not be coerced* to do so. The test of leadership during a crisis is surely a question of capable government, and is something that could have been monitored and measured by micro risk indicators in a well-designed model for political risk analysis.

Again, this book dares to contend that, had at least some of the micro political factors and their indicators been used prior to the advent and ripening of the AFC, the economic, political and social ramifications of the crisis could have been better anticipated or minimized to some extent.

Concluding Remarks

The Asian Financial Crisis, coupled with the role the IMF played in its aftermath, cannot be exempt from an investigation founded in political risk analysis. Had certain sentiment been known during the crisis build-up, hedge actions could have been taken.

By using the example of the AFC, it can be said with hindsight that it is important to consider political factors when designing a comprehensive model for

investment risk analysis. The roles of inherent political instability, regional influences, and inter-relatedness should never be underestimated. A distinction should be upheld between sovereign debt and private debt, the quality of financial sector supervision should be monitored, and the composition of foreign borrowing should be analyzed. Large current-account deficits and long-standing economic weaknesses should be monitored for cases of underlying political inadequacy. It should also be acknowledged that no risk factor or indicator, no matter how small or insignificant it seems, should be ignored. On its own it might seem harmless but the nature and impact of its relations to other risk factors can spark off an event to the extent of contagion illustrated in the AFC example.

The link between politics and economics becomes quite clear. East Asian political systems, along with their economies, were definitely tested and most probably transformed by the crisis. These changes will be welcomed by some and rejected by others, but ignored by none.

The danger, however, lies in how carefully political leaders can juggle crisis management and popular support because, with the sacrifices that people made in adjusting after the crisis, governments will face more vocal protests and demands for a greater stake in policy making. Complementing strong leadership should be stable and independent institutions able to deal with these public inputs and demands without buckling under the weight of a systems overload.

The issue of "more" democracy in an Asian *Wiederaufbau* is a contentious one. In times of crisis, the national interest might clamp down on such things as personal freedoms and civil liberties as governments tighten the reins on economies. Also, government protection and slack regulation of the well-connected can augment the problem. What is called for is a government more accountable to its electorate (if not to its electorate, then at least to the public) and more responsive to its needs with responsibility...even if it means being unpopular. In the above discussion, it was shown how limited government accountability, the degrees of transparency, responsiveness and responsibility are all political risk indicators that could well be included in a political risk analysis model.

Other factors that countries can be measured on that should greatly reduce the risk of crises include closing insolvent institutions, increasing capital requirements, easing foreign-ownership limits and restrictions, and enforcing supervisory practices that are on a par with international standards (Goldstein, 1998; Griffith-Jones et. al., 1998).

Some other financial restructuring measures agreed upon with the IMF that can be translated into factors influencing the occurrence of political risk include tight loan classification, bank licensing rules, and bankruptcy laws that meet international standards; guidelines for the assessment of owners, board members and managers of financial institutions; tight banking supervision laws, prudential regulations, strong rules governing disclosure, auditing and accounting practices; a deposit-insurance scheme; and at least a strategy in place for privatizing institutions experiencing high levels of state intervention (Goldstein, 1998). Once again, the notion is augmented that high levels of state intervention might point toward a high probability of political risk occurring.

Of further importance is the stability and ability of central banks. The answers to some questions regarding central banks are important when conducting a political risk analysis, and will be expanded upon in the next chapter. To what extent are central banks insured? How are they managed? What does management look like? What are management's qualification(s)? Who "runs" the bank, or who is in charge? What is the level of central bank independence, or what are the levels of state intervention, if any? What is the size of the foreign reserve? How many months can be "covered" by the central bank? Does it uphold the banking and financial supervisory laws it holds forth?

This chapter offered a discussion on model designing, the use of scenarios in management science, and the relevance of model underpinnings for constructing a model for political risk analysis. It also scrutinized, presented and discussed some findings of importance to political risk analysts in the light of the Asian Financial Crisis and touched on the observation that macro-type models and methodologies sent out a weak few warning signals.

In the following chapter, the political risk factors that have been touched upon so far in the book are presented in their own right. This is done by motivating their inclusion in the model for political risk analysis presented in this book by explaining their contextual relevance. In illustration of the flexibility and adaptability of the model in order to suit client and industry specific analyses, the ways in which the various risk factors can be weighted and scored are suggested in Chapter 5.

Notes

- 1 Chapter 5 offers an explanation of how the indicators are "weighed" and presents the mathematics of the model.
- 2 Private consultation with Albert Venter, 14 October 2002.
- 3 Policy instability refers to instability in government policies that impact on the business community. Increasingly, international and domestic events interact to influence policy uncertainty – from labour unrest and raw material shortages, to emission of pollutants in one country that cause acid rain in another.
- 4 The idea of "bounded rationality" was introduced by Simon in 1972, who was also awarded the Nobel Prize for Economics. In this bounded rationality, one component of rational decision making is a systematic search for options that are, it is hoped, feasible. This is in contrast to the classical approach, which seems to assume that a full set of feasible options is known at the outset. "Search" and "satisficing" are the two aspects that are embodied by rational choice.
- 5 The quantifying of qualitative observations is the topic of an ongoing debate...this book aims to show how so-called "intangible" or "soft" variables accredited to the field of social science, can be empirically observed, measured, and accounted for.
- 6 The IMF eventually provided financial support to the amount of US\$35 billion for three countries most seriously affected by the crisis, namely Indonesia, Thailand and Korea. A further US\$85 billion of financing was committed from other multilateral and bilateral sources, although not all of this financing materialized (IMF, 2000).

- 7 In the political risk analysis model designed in this book, financial indicators are included in the economic risk indicators (*Er1-36*). A political risk analysis cannot be complete, reliable and valid without incorporating the ability to measure factors that may contribute to country risk. In future studies of political and country risk analysis or in discussions surrounding the multi-discipline, mention of the AFC will no doubt still be made – if not used as an example.
- 8 <http://www.asiaweek.com/asiaweek/97/1128/cs1.htm>.
- 9 Mentioned above, Paul Krugman augmented critical thought on the rapid success of Asian economies, and wrote “The Myth of Asia’s Miracle” (1994). As early as 1982 a Harvard graduate student, Yuan Tsao, found little evidence in *efficiency* growth in East Asia (Krugman, 1994).
- 10 The literature suggests that there were three main interrelated origins of the crisis; one of these being financial sector weaknesses in Asian emerging economies combined with “easy” global liquidity conditions. Another was growing concerns about external-sector problems and a third was contagion from Thailand – first to the three larger economies of the ASEAN-4 (Indonesia, Malaysia and the Philippines), then to North Asia (South Korea, Taiwan, Hong Kong and Japan), and finally to other countries ranging from Brazil to Russia.
- 11 For one, their lack of acknowledging that something was wrong in Asia is a contributing factor to the cause and contagion of the crisis. Ratings did not even drop slowly. Only after the crisis had ripened (18 months) did ratings drop – in most cases suddenly and severely, from investment grade to junk status.
- 12 Also see *The Economist* (15 July 1997 and 13 December 1997), *The Financial Times* (8 May 1998), and *South China Morning Post* (21 January 1998).
- 13 External debt turned out to be much larger and international reserves much smaller than indicated by publicly available data.
- 14 Debtor countries feel ideologically (*dependencia*) that the industrial nations owe them at least this much or, that an appeal to the morals of IMF officials will touch a nerve in a plight for debt restructuring or the total scrapping thereof.
- 15 Mere portions of monies were salvaged from large accounts. Individuals who borrowed on credit to purchase luxury items dumped these liabilities at a fraction of the price. The supermarket, gas station, doctor’s office and school cashier upped prices to unaffordable heights.

Chapter 4

Political Risk Factors and their Indicators

Introduction

In introducing the risk factors to be used in a model for political risk analysis, Anderson (1991) and Carley (1981) offer some thoughts on the choice of these factors. One criterion for “good” factors of political risk implies that the information from which the factor is calculated, be readily available. Once an analyst knows *what* to look for, the issue of *where* to look for it becomes slightly less complicated.

Risk factors should be relatively easy to understand, and should reflect something measurable, believed important or significant in its own right, or should reflect or represent something important beyond what the factor itself is a measurement of. This is what constitutes an actual factor *indicator*, rather than just a figure or a statistic. One way to build up a set of risk factors is to decide on the most significant problems to keep track of, again emphasizing the importance of gauging a client’s specific needs to enable micro-type analysis. Depending on the client, risk factors and their indicators can also be designed and chosen to be industry specific. For example, irrigation agriculturalists or beverage producers would be interested in knowing if their investment could run the risk of water restrictions, or the indirect pollution of underground water reserves due to a lack of government oversight. These environmental risks can influence government policy on such related issues. Inherent political risks relating to the government’s authoritative allocation and distribution of scarce resources; policy effectiveness and penetration; and the economic prospects of a country, come to the fore.

This chapter will show how the research is operationalized by introducing the risk factors that have been chosen for the model. The choices are motivated by explaining the significance of the risk factors and their indicators, as well as how they are weighed and scored in the model. Of further importance is the idea that the risk factors explained are all included in the generic model offered in the next chapter. Depending on a client’s requirements and the particulars of the planned investment, some of these risk factor indicators can be adapted or even excluded from a client-specific model for a certain industry.

Measuring Political Risk

Political risk analysis per definition implies the ability to anticipate the kinds and degree of risk a foreign investor might face in a certain country. Political risk analysts have to be able to recognize signs that can act as clues to situations in which risk to an investment can occur. There is a myriad of criteria that can result in political risk, although not necessarily. Political instability for example, does not as a rule always pose a risk for foreign investment, but it might result in political risk if contributing factors augment a risky situation. These “clues” or “signs” are indicative of the presence or absence of particular political risk factors.

In a structural sequence for political risk factors, systemically organized observations present data that can be scaled numerically. For example, on a scale from zero to 30, a country’s education ratio of student:teacher can be either very bad (30), or very good (0),¹ where 26 students per teacher is a satisfactory ratio. In this way, an indicator of a country’s level of education and learning is presented in order to express such phenomena as related to political risk concerns of a certain country. If the indicators for a concept are not specified with sufficient richness and accuracy, the concept itself cannot be of much use, like “education and learning”. This book presents the reader with a set of guidelines in order to explain the operationalization of chosen factors, and to illustrate a clear link between the factor’s indicator and the concept of which it is a measurement.

The scope for further study in the field of measuring political risk allows for a more in-depth investigation into the abovementioned precision of a set of indicators used for analyzing political risk. The arbitrary nature of political risk analysis can be remedied by incorporating standardized and transparent values already attributed to political indicators. There was a surge in good databases² during the past decade or so that measure political attributes and thus enable comparative studies.³ Although this book is aware of these standardized measurements, it admits to the aim of addressing the challenge of attempting to build a unique and comprehensive model for political risk analysis in addition to these measurements. An even more advanced study should without a doubt further address remedying the more arbitrary and nominal nature of that which can be defined as political risk.

The careful use of aggregate data

The following section will introduce some of the factors that are used in the model presented in Chapter 5. This section also explains how many of these factors and their indicators can be measured by means of using aggregate data. Although the dangers involved in using aggregate data were discussed previously, it remains the way in which a country is reflected on paper (by compounding the lowest and highest scaled measurements into an average), and offers a means to compare countries. Statistical data can be manipulated by means of aggregating and averaging figures to fit a framework of political risk concerns, which is in itself easiest to come by, the easiest to work with, the cheapest and ultimately more reliable.

Arguments for and against the use of individual and aggregate data are familiar in the field of comparative studies (Anker, 1990; Pidd, 1996). In political risk analysis, one finds activities such as urbanization, industrialization and consumption that cannot be expressed in terms of individual attributes, but which are better expressed as average or aggregate figures (Carley, 1981). The availability of aggregate data over long periods of time is also an important factor in trend analysis favouring the use of aggregate data, since almost all countries collect and publish a wide variety of socio-economic, political and demographic data (Bunge, 1998; Carley, 1981). In the study of developing countries, where survey analysis is often politically and subjectively suspect, aggregate data analysis published by an independent organization, can play a useful role in generating objective information for political risk analyses which are relevant to the country being studied. But in experience though, many of the figures used and presented as country statistics in such indices are only estimates – proving that figures for certain countries remain hard to come by.

One of the basic problems of using aggregate data in analyses is the matching of empirical measures with theoretically meaningful concepts. It is not always easy to find risk indicators that retain the same meaning from country to country, considering that the relationship of analytical findings to the “real world” depends heavily on the accuracy of the measurements and the consistency of definitions over the units being studied. On the one hand, the results attained by using a generic model to conduct a comparative risk analysis between an industrialized and a developing country can be skewed, but on the other, if one uses a different model to measure political risk in such countries respectively, one is rather conducting in-depth analyses and not comparative analyses as such (Arminger, Bradley and Schaefer, 1998, Bunge, 1998; Clogg and Sobel, 1995; Rapoport, 1983; Reaves, 1992; Messick, 1968).

The various levels of analysis represented by the model present problems of their own as explained in preceding chapters. Although a lot of scope is covered, some complications still remain in using, for example, the state level of analysis in comparative analyses. Gross averages and aggregates frequently mask substantial international variations and deviations, especially in developing countries where, as an example, the will of the political elite often do not correspond at all to the needs of those being governed. Per capita income figures (be they Atlas method or purchasing power parity) often mask individuals who earn a “below average” income per annum, as well as those in privileged financial positions. Government or government-subsidized institutions often manipulate data in order to present a “rosier picture” than what should be reflected in reality. It becomes clear that the problems of comparisons, of aggregate data analysis and that of cross-level analysis are interrelated. Apart from hard economic factual figures such as per capita income and balance of payment statements, other indicators of risk may include geopolitical considerations such as the proximity of the specific country to a trouble spot or a suspected “rogue” state (Levinsohn, 2002).

Of another nature are social indicators, like rapid and concentrated urbanization – a consequence of other symptomatic factors that have to be analyzed during the political risk analysis process. Causes of political risk are infrequently attributed to

only one event or tendency in a country. Other contributing factors to political risk can be fractionalization in a country by language, cultural, ethnic or religious groups and the power these factions have to disrupt or place great strain in the form of demands on the political system. Restrictive or coercive methods required to retain or maintain power and regime stability be it (il)legitimate also play a role, as does the mentality of government and the governed, including for instance xenophobia, nationalism, fanaticism, corruption, nepotism and the (un)willingness to compromise. Social conditions include population density and resource distribution, health concerns, as well as the mobility, organization and power of political forces under an influential, fiercely ideological government. Societal conflict in the form of demonstrations, strikes and violence are symptomatic of political risk, as is instability as perceived by unconstitutional changes, unlimited government, kidnappings and hostage situations, assassinations and guerrilla activities.

As mentioned before, political risks not only encompass politics, but also economics, socio-economics, social and societal factors, environmental factors, as well as the nature and industry-specific scope of the particular business involved in foreign investment initiatives. As these elements are constantly undergoing change, the assessment of risk necessitates detailed analysis of the various features of particular cases. The reality of time and costs however, often limit the depth and scope of analysis. There is thus often a need for political risk factors and analysis models that are easy to handle and readily available, without compromising the integrity, validity, quality and accuracy of a political risk assessment. The following section explains how the factors and indicators used in the model were chosen, and motivates their inclusion.

Choosing Political Risk Factors and their Indicators

Some of the issues that one should be aware of when deciding upon the inclusion or exclusion of political risk factors and their indicators in a risk analysis model will be touched upon in the following discussion. As the discussion evolves, it will also become clear that many risk factors represent those that foreign investors are most concerned about and that most investors have in common. Other risk factors are related to these main concerns, although less obvious. The factors are not in any particular hierarchical order, since it is felt that each risk factor is significant and that the particulars of a specific environment can spark any one of the factors.

As Anderson (1991) and Chicken (1986) explain, economies do not exist in isolation of politics, or purely for their own sake. They have effects on the future of the environment and societies which are of definite importance, as society and the environment provide the inputs and resources any economy is reliant upon, be they labour or natural resources. Thus the "human" and "natural" perspectives of economics imply the use of social and environmental factors to enable the measurement of a country's economic prospects and economic performance, alongside such factors as capital and current accounts, account deficits, reserves, and gross national product statistics (Nash, 1994).

It is also important to take the nature of a society into consideration when planning to invest in a specific country. Apart from macro statistics, it is important to be aware of the culture one will be conducting business in. Different cultural perspectives invariably affect the direction of negotiations in various countries. This question becomes more intricate as it becomes less clear whether negotiations are conducted according to western or local customs (Bartholomew; 1990, Olivier; 1996, Whitmeyer; 1996). Bray (1994) explains that it may be required to adapt to Islamic banking codes in some Middle Eastern countries. Olivier (1996) is mostly concerned with a trend resulting from a mixture of unfriendly officialdom and some hair-raising experiences which has made investors, especially from western companies, wearier (Clegg, Ibarra-Colado and Bueno-Rodriguez, 1999; Lane, DiStefano and Maznevski, 2000; Wang and Tiong, 1999 and 2000).

Because the model presented in this book can be applied to conduct comparative analyses, one would think that a single set of risk factors would be used for such cross-country comparative analyses. Yet different factors will be more significant in some countries than in others, and there will always be cases where there is a need to highlight additional risk factors not relevant for worldwide comparisons. Still, it would be wrong to exclude risk factors on the grounds that the contrasts they show are too stark, and to say that completely separate sets of factors should be regarded as appropriate for both developed and developing countries (omitting indicators for the loan default factor when rating a developing or highly-indebted country, will not improve the investment climate). This would negate the cross-country nature of political risk analysis in enabling comparisons of two or more countries. Granted, should an in-depth study of a certain country be required by a foreign investor, the political risk analyst would serve that client best by excluding, choosing, and using specific factors and their indicators best suited for a specific country, industry or time-span of the investment (short, medium or long term). Suffice it to say that this book makes both in-depth country and micro industry analyses possible, but presents a model that also enables cross-country comparison and analysis.

Political risk factors should reflect reality, not merely present those aspects of reality that can be evaluated easily, and should not have to carry an automatic evaluation (Anderson, 1991; Carley, 1981). It does not always have to be "good" if it goes up, or "bad" if it comes down (inflation rate); or always "good" if it comes down, and "bad" if it goes up (life expectancy). Using socio-economic, societal and environmental indicators, and not just purely financial indicators, is a valid means of evaluating economies as well as the economic *prospects* of countries, which invariably influence the political and investment climate of a country and its people as the interrelatedness of politics, economics, and social conditions become clear (Anderson, 1991).

As mentioned earlier, political risk analysis involves components of both macro risk and micro risk, and risk factors are drawn from these components in order to conduct both a generic-type and specific-type political risk analysis (Venter, 1999). Model flexibility and adaptability accommodate both these components, as the model will aim to show. The following section will start to explain the choice of risk factors and their indicators.

Sources of political risk factors and their indicators

The purpose of political risk analysis is to point out problems and to give advice as to how one could approach the country in which a company is interested in pursuing certain opportunities. Among other important factors both Raddock (1986) and Bunge (1998) investigate, is the repatriation of capital and remittance of profits. The question justifying such indicators is founded in the (in)ability of prospective investors to get their money out of a host country. The political risk analyst should advise investors as to how to manage such limitations. Yet, if a country faces a currency conversion crisis, or if there is a reason to suspect contract repudiation, investors should be advised not to approach such investment climates without the necessary guard.

The “economics of political risk” is not a contradiction in terms. If government makes decisions or rules as to the economic systemization of a country, policy is made. And where policy is made, politics is involved. Decisions have been made in the past, often without somehow consulting the populace regarding the economic route that a country might take under authoritarian rule or under a dictatorship.

Further risk factors may include an extremely uneven distribution of wealth between individuals and between cities and rural areas; a high debt burden coupled with near zero economic growth; an adult work force of which only 50 per cent is adequately employed or might have contracted HIV/AIDS; an acute population growth problem; a large number of politically aware young people entering an overburdened job market; an outmoded land tenure system; hyper urbanization; and consequent urban over-population. Add to these factors severe economic jolts, which stem in part from global conditions, and political risk analysis is called for as well as a deserved look into the dimension of socio-political interaction.

In assessing political risk, MNCs must give ample weight to elements such as political control and to the mentioned cultural constraints against successful challenges to the existing order, be it one of authoritarianism, tyranny or even dictatorship. In the above example, threatening urban conditions that pose risks like an unstable and dense population, health risks, unemployment, increased political awareness and a broad network of communication are often counter balanced by stabilizing cultural elements and by the absence of significant organizational structures that can serve as alternatives to the ruling party.

Economics as a contributor to political risk levels is certainly most important. Macroeconomic and fiscal policy, economic planning strategy and the broad framework for the development path of a country are determined by decisions taken by governments. This framework is a major determinant of the economy's performance and flexibility, and is closely bound up with the political structure in which foreign investors are interested when considering a more profitable investment climate.

Political Risk Factor Indicators as a Measure of...

Initially, an *overview evaluation* of the macro political and economic environment of a host country is necessary. Some of the questions that need to be addressed in an initial analysis, for which indicators have to be identified in order to recognize the risk factors pertaining to these factors, include the nature and stability of government; the institutional functionality of government (if not functioning well, personalities – on an individual level of analysis – might become more important); identifying the key personalities; identifying the decision makers and their power base; the stability of investment regulations; as well as economic pressure on government and its policies from the political opposition or other power.

At the very least, the abovementioned questions relate to questions of political stability, economic stability, and operational obstacles. These include questions about the political environment, the military, human rights issues, infrastructure (including communication and transportation), corruption, contracts and tendering processes, vested interests, the bureaucracy, indigenous people, legal shortcomings, crime, kidnapping and extortion, border conflicts or war, and urban terrorism (especially as part of a micro analysis, against a tourist industry for instance).

If required, a second or *specific analysis* complements macro political risk assessments by identifying risks associated with the particular project itself. Micro-analysis addresses the issue of determining the best structure for a proposed project or investment. These issues include retaining sufficient control if a company is involved in a partnership with a local firm; the reputation, background and political connections of a company's partners; and cultural nuances a company should be aware of when embarking on business transactions in a foreign country.

Other micro analysis type issues include the strategies that can be implemented to strengthen support for the project; the political conditions of the relevant geographical location; the relationship between central government and regional government; the attitude of local communities toward the proposed project; the presence of any armed opposition groups in the area (their attitudes toward the presence of a foreign company, the security risks to people and operations); the "winners and losers" from the proposed project; sectarian unrest; the police; local taboos and even the availability of pharmaceuticals and emergency care.

...the major risk factors of concern to most foreign investors

What the bulk of literature on political and country risk analysis has in common are overlapping areas that are of major concern to foreign investors. This leads one to believe that there are certain major risk factors that most foreign investors have in common. These risk factors are a good departure point when choosing factors for inclusion in a political risk analysis model. Consequent risk factors might seem less significant, but are by no means less important, as they are very closely related and causally linked to the major factors explained in the following section.

Literature suggests that political stability, political effectiveness, monetary policy, exchange rate policy, trade policy, fiscal policy, the regulatory environment, the global environment, debt, growth, the financial structure, current

account, and liquidity of a host country are the overarching concerns of foreign investors. These concerns will be addressed in the following section.

Political stability

Political stability can be measured by monitoring incidents of internal and external conflict; social unrest; orderly political transfers; politically motivated violence; government stability; policy stability; socio-economic conditions; military in politics; religion in politics; law and order; ethnic tensions; and international disputes. Government stability is a measure of both the government's ability to carry out its declared policies, as well as its ability to retain office. This is influenced by the type of governance; the cohesion of the government and governing party or parties; the proximity of the next election; government's command of the legislature; and popular approval of government policies whilst still governing responsibly.

Regime legitimacy also contributes to political stability. A political system under fundamental stress from severely disaffected groups, and the laws of the land being questioned might pose strains on the legitimacy of a regime. A change in government that would bring to power a set of leaders with a different political philosophy, or a new strategy of economic development that could undermine investor confidence and upset policy continuity, does not bode well for foreign investment. If a change of regime brings to power supporters of debt repudiation, a country's investment climate will surely not remain untouched.

Political effectiveness and accountability

Investor confidence in a country is usually boosted in cases where political institutions are robust – responsive to challenges, resilient to shocks and flexible under pressure. The management of debt obligations in both favourable and unfavourable economic circumstances also indicates political effectiveness. Even more so, if under adverse conditions, authorities have been able to draw up and implement a coherent program of economic restraint. Of concern in this case is change in government orientation in the sense of business orientation (from pro-business for example); institutional effectiveness; the quality of the bureaucracy; transparency and fairness; democratic accountability; corruption; and crime.

As a political system, the essential features of an accountable democracy include a systemic transparent government or executive that has not served more than two successive terms; free and fair elections for the legislature and executive as determined by a constitution or statute; the active presence of more than one political party and a viable opposition; evidence of checks and balances among the legislature, executive and judiciary; evidence of an independent judiciary; and evidence of the protection of personal liberties through constitutional or other legal guarantees. As a measure of how responsive government is to its people, it is assumed that the more democratic a society is, the more accountable it is, and is in turn probably less susceptible to sudden or explosive political shocks.

Socio-economic conditions

This features as an attempt to measure the quality of human capital and general public satisfaction, or dissatisfaction for that matter, with a government's economic policies. It is assumed that the greater the public dissatisfaction with a government's policies, the greater the chances that the government will be forced to change its policies, possibly to the detriment of foreign business. In this model, socio-economic conditions cover a broad spectrum of factors including infant mortality, medical provision, housing and interest rates. It is also assumed that different factors will carry different weights in different societies. As an example, a three percentage point rise in unemployment can have a highly significant political impact in a country that has enjoyed an unemployment rate of, say, 4 per cent. The same rise would probably go unnoticed to the public in a country where unemployment is for instance in excess of 30 per cent.

Internal and external conflict

Internal conflict is an indication of political violence in a country as well as its potential or actual impact on governance. A low risk rating can be given to a country where there is no evidence of armed opposition to the government and the government does not indulge in arbitrary violence – directly or indirectly – against its own people. It is assumed that a high risk rating be given to a country embroiled in an on-going civil war. Intermediate ratings could be awarded on the basis of whether a threat is posed to government and business, or only business (kidnapping for ransom); whether acts of violence are carried out for a political objective; whether such groups are composed of a few individuals with some support, or are well-organized movements operating with the tacit support of the people they represent; whether acts of violence are sporadic or sustained; and whether they are restricted to a particular locality or region, or are carried out nationwide.

Membership of regional organizations or bodies that imply a certain economic status may provide a cushion of support in times of stress and a commonality of interest in general policy matters. Political factors that create ties of alliance with major industrial powers that would offer safety in the form of continued access to funds when other sources are closed off also reduce risks to foreign investors.

The measure of external conflict is an assessment of both the risk to government and to investment. It can range from qualitative-type conflict like trade restrictions, embargoes, and geopolitical disputes; to armed threats, exchanges of fire on and across borders, foreign supported insurgency and full-scale war. External conflicts can adversely affect foreign business in ways ranging from restrictions on operations; to trade and investment sanctions; to distortions in the allocation of economic resources; and violent change(s) in the structure of society.

Corruption

Corruption within the political system is a threat to foreign investment for several reasons. It distorts the economic and financial environment, reduces the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability, and introduces an inherent instability into the political process of a country. The most common form of corruption met by business directly is financial corruption in the form of demands for special payments and bribes connected with import and export licenses, exchange controls, tax assessments, police protection or even loans. Such corruption can make it difficult to conduct business effectively and in some cases may force the withdrawal or withholding of an investment.

Job reservation, nepotism, excessive patronage and suspiciously close ties between government and business are especially risky to foreign business in the sense that they can lead to popular discontent, unrealistic and inefficient controls of the state economy, and can encourage the development of a black market. The greatest risk in such corruption is that, at some point, it becomes so overwhelming that a major scandal can provoke a popular backlash, resulting in a fall or overthrow of the government; a major reorganizing or restructuring of the country's political institutions; or a breakdown in law and order that can render a country ungovernable.

Military in politics

As the military is not popularly elected, its involvement in politics even at a peripheral level reduces democratic accountability and can be quite significant. A situation in which the military becomes involved in government because of an actual created internal or external threat, would imply the distortion of government policy in order to meet this threat, for example by increasing the defense budget at the expense of other budget allocations.

The threat of a military coup can force an elected government to change policy or cause its replacement by another government more agreeable to the military's wishes. A military coup or threat of a coup may also represent a heightened risk if it is an indication that the government is unable to function effectively and that the host country therefore presents an uneasy environment for foreign business.

In the short term a military regime may provide new stability and reduce business risks; but in the long term, the risk will probably rise, due to the system of governance becoming corrupt(ed), and partly because the continuation of such a government is likely to create an armed opposition. Military participation in government, to varying degrees, might be a symptom rather than a cause of underlying difficulties within a country.

Religious tensions

These may stem from the domination of society and/or government by a single religious group that seeks to replace civil law by religious law, and to exclude other religions from the political and/or social process; the desire of a single

religious group to dominate governance; the suppression of religious freedom; or the desire of a religious group to express its own identity, separate from the country as a whole. The risk involved in such situations range from inexperienced people imposing inappropriate policies, to civil dissent and civil war.

The quality of the bureaucracy

The institutional strength and quality of a country's bureaucracy tends to minimize revisions of existing policy when governments change. Less risky to foreign investors are countries where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services. In such instances, the bureaucracy tends to be somewhat autonomous from political pressure and usually has an established mechanism for recruitment and training. Countries lacking in these respects tend to pose more risk to foreign investment because a change in government tends to be traumatic in terms of policy formulation and administrative functions.

Inexperienced and corrupt public officials can delay economic plans or reforms and undercut policy intentions by siphoning off resources from the legitimate pursuit of wealth creation. Signs of bureaucratic quality include efficient and effective distribution of resources; policy delivery; and middle levels of government bureaucracy staffed with competent civil servants who can translate policy into action with a minimum of delay and drain on public resources. The presence of well-trained and experienced technocrats among the political and managerial elite of a nation, adept at managing internal and external debt, also contributes toward a quality bureaucracy.

Monetary and fiscal policy

A country's political system can enhance or detract from its ability to create wealth and maintain strong export earnings needed to meet future foreign debt servicing. Low risk countries have laws and a judicial system conducive to commerce, capital investment, and the release and protection of creative economic energies. In such cases, fiscal or administrative rules do not hamper the efficient flow of goods, services and capital; and entrepreneurs in export industries are rewarded and not penalized by tax laws or even cultural biases. It is also in some cases necessary to assess whether the officials in charge of economic management are prepared to recognize and respond to both economic and financial problems in a timely manner (the Asian Financial Crisis being a case in point).

Extensive or unwarranted involvement of political considerations in the policy process can lead to a failure to meet debt-servicing obligations. Highly politicized key agencies of government usually generate more risk, as is the case where a central bank is not able to act independently of the political process, but rather acts as a tool for partisan decision makers.

The inflation rate itself and the direction of the inflation rate; policies that favour savers; the ability to boost interest rates; monetary stability; the use of indirect instruments of monetary policy; real lending rates; boom/bust scenarios;

and financial liberalization are measures of monetary policy. The ratio of public-sector budget balance to GDP; cumulative years of a public-sector budget balance; government's ability to generate tax revenue; public debt as a part of the GDP as such; as well as the direction of public debt as a part of GDP plays a role in measuring the quality of fiscal policy penetration.

Exchange rate policy and trade policy

In this case, the real appreciation of the exchange rate; the evaluation of real appreciation; the exchange rate regime; a change in prospects; expectations of a regime change; interest differentials; and the black market or dual exchange rate come into play. With regards to trade policy, the degree of trade liberalization and exports as a percentage of GDP is, among other factors, of importance.

Growth within a global environment

A host country's record of national savings as part of the gross domestic product (GDP); fixed investment as part of the GDP; pension systems; investment efficiency; average real GDP growth; latest real GDP growth; global short-term interest rates; global real GDP growth; international financial support; and the "contagion effect" are measurements of the global environment.

Current account and debt

Cumulative years of a current account deficit; the direction of the current account; the magnitude of the current account; the current account deficit as such; a reliance on single raw material export commodity; reliance on single export category; and the annual rate of growth of export receipts are measures in this case. A history of debt default; total external debt against exports; the debt-service ratio; and interest due against exports are measures that are debt-related.

Political Risk Factors and their Indicators Used in this Model

In the following section the political, economic and social factors used in the model of political risk analysis are offered as first-tier operationalization of the research by motivating their inclusion in the model.⁴ The "how to" or second-tier operationalization is presented in the next chapter, where the *indicators* of each risk factor and indicator weights are offered.

Political factors of investment risk

Pr1-Political system Within a political system, political and civil groups and institutions (or subsystems) are connected with one another, enabling the analysis of the system as such (Bunge, 1998; Mahler, 2000; Papadopoulos, 2001). This pre-supposes their existence and presence within a system, especially in the case of

civil society. The important connection among these institutions is power, and the relationships that define the levels and nature thereof. These relationships or power patterns are of concern to the foreign investor. The “rules” that govern the way in which a democratic multi-party system is organized is more conducive to foreign investment, presupposing an open economy and society. This stands in contrast to the “rules” that govern the power patterns in a one-party dominant democratic system for instance, where policy is probably largely uncontested and inputs mostly limited. The branches of government are probably not autonomous, and levels of government accountability low (Venter, 1999).

Pr2-Separation of powers The over-centralization of power is dangerous, and political power should be held in check and balanced. Although the functions and powers of legislatures vary within respective political systems, the power to pass legislation is vested in this institution, thus supposedly negating instances of executive dictates or policy decrees. Legislatures allow for the expression of public sentiment and manifest the social system in the form of legislative decisions. Political decision making resides in the office of the executive, where the executive is – in some cases – also a lawmaker, and not *the* lawmaker. Although legal systems and courts are system specific, it is assumed that they remain explicitly excluded from the political arena (Collie, 1988; Huntington, 1971; Mahler, 2000; Venter, 1999).

Pr3-Openness of political system and Pr32-Domestic openness The assumption is that the more “domestically open” a society is, the more tolerant it will be to foreign business. The nature of government policy directly influences the level of domestic openness as a whole (Bunge, 1998).

In an open political system elites, civil society, and political parties compete for recognition of their inputs in, and influence of, the “rules” that govern a political system. The degree of competitiveness is a measure of the level of political openness, as well as the degree to which competition can take place for determining public policy by bargaining and compromise. This links up with the degree of access the public has to participate politically, government responsiveness to the public, as well as government responsibility. A responsible government acts in the best interest of the public regardless of popularity and can be held accountable for policy promises by societal expectation. The more open a political system is, the more transparent its decision making process and policy environment is – making it more stable and predictable for the foreign investor (Dale and Davies (eds.), 1994; Venter, 1999).

Pr4-Public accountability of government It is assumed that a government should be held responsible for both its actions and inactions. Policy shifts should be explained, and if anticipated expectations are not met, government should offer rational explanations for such failures. A public protector or auditor-general that is intimidated by the state implies a government that does not deem itself publicly accountable. Oversight mechanisms such as parliamentary oversight, should act as a check and balance in the name of public accountability. The separation of the

public and private spheres should be concrete and not conditional to government fancy (Venter, 1999).

Pr5-Economic planning issues Reasons for economic planning failures include deficiencies in plans and their implementation; insufficient and unreliable data; unanticipated economic disturbances (external and internal); institutional weaknesses; and a lack of political will (Todaro, 1989). Repeated failures in meeting economic plans or promises imply "bad" economic policy and, if domestically caused, a symptom of policy inefficiency, inability and incompetence. In all probability, government accountability for such failures becomes less pronounced and irresponsible economic targets are used in speeches made around election campaigns. Such cases of misleading economic policies are probably popular in the short term but when social expectations are not met, conditions for social uprising are amplified (Bunge, 1998).

Pr6-Form of government In this case, it is assumed that the factors relevant to establishing a country's form of government indicate government stability. In cases where a change in executive leadership leads to drastic policy change, instability is heightened. On the other hand, in cases where a change in political leadership sees a steady continuance of policy, government stability seems evident (Bunge, 1998; Dale and Davies (eds.), 1994).

Pr7-Racial, ethnic, religious, nationality, language issues It is assumed that these kinds of tensions are less prevalent in homogenous societies than in countries where the political distribution of resources and voting is sometimes found to occur along traditional or ethnic lines. Ethnic clashes are often politically motivated and often blamed on ethnic bias within government, and battles of autonomy for ethnic regionalism are not only common in developing countries (as evident in Basque Spain). The level of government legitimacy as expressed by various ethnic groups is often manifested in occurrences of racially or ethnically motivated violence, and often around election time (Venter, 1999). A loss of group autonomy can motivate ethno-political protest and secessionist movements, and the greater the group's identity, the greater its potential for mobilization. External support for ethnic groups with a shared history can greatly contribute to the extent of ethno-political uprising.

Pr8-Border disputes/external conflict and international relations Wars of secession are a good example and a case in point would be that of Eritrea. Having seceded from Ethiopia in 1993, sporadic battles have continued and the final borders have only recently been drawn. The result of this secession leaves Ethiopia landlocked and Eritrea with a harbour, where such a port is a very important infrastructural resource, enabling access to and from Eritrea for the exchange of goods (Venter, 1999). Frequent or severe inter-state political or territorial disputes can undermine regional security. Armed conflict in neighbouring states can have a destabilizing effect on national stability, through the

flow of cross-border refugees or rebel movements, or through contributions to regional war chests.

Pr9-Political terrorism The distinction between political terrorism and guerrilla activity can be unclear. The assumption however, is that terrorism is the use or threat of violence or violent means in order to coerce a government, authorities or entire populations by inducing fear. Terrorism seeks to influence political policy and behaviour of a government through extra-normal means, usually having tried and exhausted conventional political options like negotiations and efforts at diplomacy. Terrorism is strongly influenced by perspective, as some terrorist acts are often labeled acts of national liberation. Terrorism is also used for more random acts of violence like environmental and nuclear terrorism; terrorism aimed at multinationals; lobbying for environmental concerns; against foreign policy issues; or for the release of political prisoners (Bunge, 1998). Terrorist targets are usually civilian and responsibility is often claimed for such attacks; if not, the purpose of the attack is somewhat defied. On the other hand, guerrilla action tends to focus attention on government targets (usually military), rather than random civilian targets. Any such acts are significant because they offer fundamental challenges to the institutions of a government and operate outside the system, rejecting the means of the political system to handle their demands (Clutterbuck, 1977; Mahler, 2000; Thackrah, 1987).

Pr10-Militarization An explanation of the role of the military in politics shows that it is not only participation that is crucial for governments, but also the type of participation that takes place. The assumption is that within a political system, the military agrees to accept the consequences of the policy-making process and accepts a subordinate (but not insignificant) role in the political system. In military regimes, military leaders still face the same problems as executives of civilian governments face – that is keeping military underlings loyal and preventing an overthrow of the military power. The role of the military in a political system is affected by a country's political culture, history and tradition – literature suggests that in some Latin American countries the idea of a military coup, if not desirable, is definitely recognized as a statistical probability (Mahler, 2000; McDonough, 1983).

Militarization is indicative of a conflict ridden political culture, where parties resort to violence as a means of airing grievances. In such cases, states are often incapacitated to resolve conflict through institutional channels, and armed forces are more able to engage in political disputes. A state's lowered capacity to provide security can result in an erosion of popular support for state institutions and in the population's consent to be governed.

Pr11-Legitimacy issues The assumption is that, the higher the level of government legitimacy, the higher the level of public consent to be governed, and the less chance there is of legitimacy crises, political violence and social uprising. Every state experiences these crises during its process of political development though. After hundreds of years of such development many states are established and stable

in that sense. States with prolonged legitimacy crises and especially relatively “young” states are cases in question. The terms “political development” and “political modernization” are often used interchangeably. Identity crises imply that individuals have trouble describing themselves politically, which result in problems of associating themselves with government. Policy penetration refers to government’s ability to follow through on and enforce its decisions. Governments that are not able to do this are assumed to be less stable. Too little public participation may result in a lack of legitimacy, just as too many demands made on the political system may overburden a government that is supposed to respond to such inputs. The inequitable distribution, or even insufficiency of material resources like food, medical supplies, housing, as well as water and electricity, is a great concern in many developing countries. A society in which a group feels that it is not receiving its due share of material benefits from government, is probably more prone to uprising (Carley, 1981; Huntington, 1968; Mahler, 2000; Winter and Bellows, 1977).

Pr12-Government behaviour As a cross-reference to Pr4, the assumption is that the more responsibly a government governs the more likely it will account for its actions, expenditure and policy decisions. Constitutional government implies limited government, where there are boundaries to government involvement (in the private sphere, be it business or individual), and there are certain things a government “just can’t do”. This does not imply that a government with a constitution governs constitutionally (Zimbabwe). Many of the most constitutional governments do not have a written “single-document” constitution as such (Great Britain). A high level of political transparency assumes that government probably allows for large amounts of quantity and quality public input (Venter, 1999).

Pr13-Consequences of social revolution A revolution typically refers to a changing of one government or type of government for another. This can involve a sudden and often illegal attempt to change the regime of a state, or can involve extra-governmental political organizations of which large sections of the population are participants. On the other hand, revolutions might seek to restore legality against a regime that has violated a country’s laws and such a revolution might thus be deemed “legal”. A mass revolution (French, Russian, American, Chinese) involves significant and radical changes in the ruling class, whereas a *coup d’état* is a sudden seizure of power from “above” instead of using the masses from below. In many cases, the leader of a coup was often very close to the centre of power, a member of cabinet, and often a minister of defense (Mahler, 2000; Venter, 1999).

Pr14-Political (in)stability After a politically scandalous event has become public, a time of political uncertainty and instability usually sets in because a public as well as a government reaction has yet to manifest itself. In a parliamentary system, executive scandal can lead to a “fallen” government as support for the prime minister discontinues, and even developed countries are not exempt (as the resignation of the Dutch government in April 2002 shows). The important thing is

that, in countries where the erosion of political institutions has set in, chances are that such systems are more vulnerable to instances of political instability and political disequilibrium. For a foreign investor, sudden changes in government policy point toward political instability and potential for further unanticipated shifts (contract repudiation, cancellation of licenses).

Pr15-Civil war Civil war, or any armed conflict for that matter, poses threats to foreign investors in the form of malicious damage or infrastructural damage to property, looting or personal threats. In many cases, civil war is often limited to certain areas within a country, but does not negate the possibility of guerrilla or terrorist attacks. Resource wars are often civil wars as well, where powerful warlords battle for control over for instance rudite and diamond resources, or oil fields. The activities of private military companies (PMCs) in a country may also indicate the presence of civil war (Venter, 1999).

Pr16-State of emergency The fact that it is or was necessary to declare a state of emergency is worrying in itself. Other degrees include a state of rebellion and the extreme case of a fallen state (Somalia). In some cases martial law, curfews and state of emergency laws can be imposed. Often called to prevent or counter political upheaval, a state of emergency also implies a tightening of trade policy, a possible closing of markets and borders, import and export controls, as well as exchange controls.

Pr17-Economic expectations and reality Economic expectations publicized by government should be based on rational factors. The disparity between the economic reality in which consumers (the public) live and government economic expectation should not be large. Expectations are notional views about certain variables like future interest rates, prices or tax rates and are said to be rational if they are not systematically wrong or "biased", and if they use all available information. Adaptive expectations are formed on the basis of past behaviour (Kischka (et.al. eds.), 2000; Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992). Unrealized expectations regarding opportunities for economic and social advancement increases discontent and augments the likelihood for political risk and civil strife.

Pr18-Leadership succession issues In a country that has shown a tendency for unlimited executive terms of government, the lack of an identifiable successor to an executive is alarming. Terms of office are often entrenched in a constitution, but unlimited executive power with no means of checking or balancing such power, can steamroll amendments through an incapacitated legislature (Venter, 1999).

Pr19-Military in politics The role of the military in politics has always been a contentious one, and can include rising or dropping government expenditure on defense, to military coups and revolutions. In many cases the military is regarded as the elite institution in developing countries. It is a structure that can be highly

significant in shaping the type and style of political participation permitted in a country. In many instances political leaders are more concerned with what the military reaction will be to their decisions than with the reactions of legislatures, the courts, or the public. The maintenance of civilian control in developing countries is a sensitive issue, especially in cases where political institutions have not yet reached high levels of development and stability. The key seems to be setting limits within which leaders and members of the military accept a government's definition of appropriate areas of responsibility. Military rule has negative correlations with economic development and often results in political regression (Mahler, 2000).

Excessive military expenditure is indicative of a general militarization of the state apparatus and increased military involvement in political affairs. The size of military expenditure often reduces the amount of social sector investment in negation of developmental issues, which can in turn influence the degree of government legitimacy. On the other hand, fluctuating military spending has the potential to create tension within the armed forces. Regional security and the balance of power are also influenced by sizes of military expenditures and the trade in weaponry.

Pr20-Erosion of domestic support for the regime Within a democracy government enjoys support from a majority of voters. If this support declines, it can be seen as a symptom of discontent with government behaviour or policy output. In some developing countries, support from the disadvantaged masses also ensures continued office, but with less of a means of policy coercion behind it as is the case with middle class support. Nevertheless, an erosion of popular consent and confidence in government is troublesome for a continuous and stable policy mandate (Kotze, 2000; Raddock, 1986).

Pr21-Unconstitutional change of government An unconstitutional change in government is closely correlated with instances of political violence in the form of a (military) coup or revolution, or even an assassination. Statistically, the past occurrence of unconstitutional and unanticipated changes in government increases the potential for such change(s) to take place again. The assumption is that such changes are in direct negative correlation with political and government stability (Venter, 1999).

Pr22-Ideology as a political factor Ideology gives a government its sense of purpose, and thus relates directly to the critical components of a government's relation to political ideas and political behaviour. Political ideology is often cited as a contributing factor to political risk. Different from credit risk, a country might be able to service its international loans or repay its debt but might avoid doing so. In turn, it follows that a country might be able to lend money to another but refrains from doing so citing reasons that are ideological in nature (Bunge, 1998; Venter, 1999). In Cote d'Ivoire for instance, *Ivorité* or the ideology of "Ivorianess" fuels the smouldering fire of ethnicity.

Pr23-Organised religion in politics Organized religion in politics can be extreme as in the past case of the Taliban in Afghanistan, can manifest itself as praying before political meetings, or as inherent values like those of Buddhism or Zen. Religious minorities are often underrepresented in legislatures, but the assumption is that the role of a legislative official should remain that of representing the public. Trouble sets in when the public good is compromised by religious zeal in politics (Venter, 1999).

Pr24-Demographics, tradition and parochialism Demographic change is part of the evolutionary process of economic modernization, as countries develop from being predominantly agrarian in nature to becoming technologically sophisticated. This process is usually slow and stable. But current developing countries are forced to “catch up” with modernized industrial countries in order to compete in international markets. Sudden changes in the demands for production have seen a decline in rural populations and increasing demands placed on urban centres. Uncoupled with political development, clashes between tradition and modernity in society can lead to incidents of violence. Uncontrolled urbanization often places a burden on the state system to provide for mounting social needs, and institutional and physical infrastructure often fall short of handling rapid urbanization by a destabilizing dense urban population (Bunge, 1998; Carley, 1981).

Pr25-Corruption/nepotism in government and rent-seeking Corruption implies that a transaction takes place between a corruptor and corruptee. Having mentioned the race for modernization, of great potential significance may be the influence of “rich-country” social and economic standards on developing country salary scales, elite lifestyles, and general attitudes toward the private accumulation of wealth. Such attitudes can often breed corruption in a privileged minority. The effect of corruption is that it creates vulnerability among countries in which forces largely outside their control can have decisive and dominating influences on their overall economic and social well-being. Contributors to corruption are trade restrictions; government subsidies; price controls; multiple exchange rate practices and foreign exchange allocation schemes; low wages in the civil service; natural resource endowments; and sociological factors. Consequences of corruption include lowered investment and retarded economic growth; misallocation of talent; reduced aid flows; loss of tax revenue; adverse budgetary consequences; lower quality of infrastructure and public services; and a distorted composition of government expenditure. Transparency International, as well as Gallup International both publish annual ratings or corruption indices, and are both a good measure of the perception of corruption within countries and industries (Kischka et.al. (eds.), 2000; Lane, DiStefano and Maznevski, 2000; Todaro, 1989; Venter, 1999).

Pr26-Law tradition The authoritative allocation of resources with which politics is concerned deals with laws. The rule of law protects individuals from government and from one another as a system of rules and regulations that maintains order in society and in government business, thus organizing both the public and private

sphere. No government or executive should be above the law. The socio-economic explanation that crime levels and the degree of lawlessness in a country are directly correlated, are often offered together with observations of a culture of non-payment in some societies (Bunge, 1998; Carley, 1981; Kischka et.al. (eds.), 2000). Past unexpected government repudiation of contracts or remittance policy changes also place a government's adherence to the rule of law in question. It is assumed that a country that engages in international trade is party to many international trade regimes and complies with the international standard rule of law. Although adherence to the International Court of Justice (ICJ) is not mandatory, some governments have instituted Commercial Courts that also allow for international arbitration.

Pr27-Status of the media The degree to which a government "allows" freedom of speech indicates its willingness to limit its power over such public mechanisms. It is assumed that a government or executive that is prone to restricting media freedom is probably also very sensitive to criticism. Censorship laws and rules regulating public access are also an indication of government tolerance to foreign influences and might even indicate to a greater or lesser degree the role that ideology or even religion might play in politics. The status of the media basically reflects the freedom granted to the news media to report and editorialize (Borsuk, 2001; Venter, 1999; Wolfsfeld, 1984).

Pr28-Human rights record As an indication of the adherence to the international standard rule of law, a country's human rights record also serves the purpose of indicating levels of government tolerance when challenged or threatened. A country's human rights status is also used as a benchmark for acceptance into international organizations and can even serve as a non-tariff trade barrier.

Pr29-Quality of the bureaucracy As the size and scope of the bureaucracy is quite extensive in any country, in many developing countries the bureaucracy or government is the main employer and a vehicle for job creation. By measuring the amount of state-owned enterprises (SOEs) in a country together with government offices, the extent of a bureaucracy can be gauged. Bureaucratic delays cost foreign investors large amounts of money. Top-level appointments in any bureaucracy are often political appointments and reshuffling of offices can be expected around election time. The function of a bureaucracy is basically to administer the policy of the executive and to advise that office, not to make policy of its own as bureaucracies are not elected by popular franchise. The growth of bureaucracy is often worrisome, but often deemed necessary in order to administer increasingly complex social policy. However, the size of a bureaucracy is not directly related to its level of efficiency or policy effectiveness (Beetham, 1987; Heady, 1984; Lefort, 1986; Mahler, 2000; Weber, 1978).

Pr30-(Lack of) political will A cause of planning failures is not simply a lack of domestic economic potential within a country nor even inadequate administrative capacity. Poor plan performance and the growing gap between plan formulation

and implementation can also be attributed to a lack of commitment and political will on the part of many developing country leaders and decision makers. Political will further entails political courage to challenge powerful elites, internal conflicts and interest groups. It also includes the will to extract public revenue from more accessible sources in order to finance projects – especially development projects in developing countries. It is assumed that levels of political will are relatively higher in decision and policy makers that show strong leadership (Todaro, 1989).

Pr31-Involvement in international organizations Membership of multilateral or bilateral agreements is an indication of international compliance. Conditions for and prerequisites of membership often involve factors like democratic principles, a free and open market, a “clean” human rights record, and political stability. Multilateralism involves a policy of acting in concert with other countries to achieve certain objectives (Evans and Newnham, 1992). Membership also indicates a commitment to “openness” and an acknowledgement of the increasingly interdependent nature of international business. Participation in international organizations assist in decreasing political risk by enforcing rules and processes by which disputes can be resolved peacefully.

Pr32-Geographic position and geopolitics Geopolitics is a method of foreign policy analysis that seeks to understand, explain and predict international political behaviour primarily in terms of geographical variables such as location, size, climate, topography, demography, natural resources and technological development and potential (Bunge, 1998; Levinsohn, 2002). The idea that political identity and action is determined by geography can play a role in political risk analysis to a larger or smaller degree (Evans and Newnham, 1992). The contagion effect of the Asian Financial Crisis is also a case in point that illustrates the effect that regional location and vulnerability can have (Heaney and Hooper, 2001). Regional tendencies can also be monitored in an attempt to identify signs that countries, as yet untouched by events within a region, might be on their way to experiencing the same circumstances.

Pr33-Contract repudiation by government The assumption is that the more cases of contract repudiation and license cancellations there have been in the past, the greater the probability of it occurring in the future, and the lower the levels of political, government and policy stability are. The provisions that can be made for hedging against such events, by particularly including this in a contract during negotiations, does not really hold fast. In such cases, political risk insurance coverage is probably the better option, or even agreeing to extortion-type agreements in order for such events “not to happen” (Brewer, 1986).

Pr34-Selective discrimination Selective discrimination is a phenomenon that can hardly be expected. Yet it is possible to look for the “types” of industries that have been discriminated against in the past in order to look for the reasons why, or the events that led up to such discriminatory practices. This enables decision makers to strategize around such findings in anticipation. Foreign operations that are very

profitable actually run a greater risk of experiencing selective discrimination, ironically enough because of their apparent prosperity. Political risks may alter operating cash flows via discriminatory regulations (Feils, 2000).

Pr35-Political violence Instances of political violence include acts of terrorism, guerrilla warfare, and revolution as modes of political “participation”. Although often restricted to a certain area or areas within a country, the spin-offs of international occurrences can be brought close to home. The implications to foreign and domestic business can vary to certain degrees – from limitations in supplies necessary for production, interrupted government services, damage to physical property, kidnapping, or even complete abandonment of the operation.

Pr36-Elections The assumption can be made that, in the months preceding and following a national election or any election for public office, the more politically stable a country is, the less incidences of political violence, intimidation, unforeseen policy changes and constitutional amendments there will be. Sudden changes in election laws as well as irrational executive decrees, also contribute to the degree of irregularity surrounding an election. The degree to which government policy is “spin-doctored” around election campaigns, is an assumed indicator of government tolerance, competitiveness within the political system and overall political openness of a country. The more “untouchable” a government and its decisions are, the less competitive a system becomes and the less tolerant it will probably be of public and private opposition.

Economic factors of investment risk

Er1-Degree of liberalization It is assumed that an open economy engages in international trade of goods and capital with other states and floats its currency on the open international market. Central bank activities include buying or selling government bonds to influence bank reserves, the money supply, and interest rates (Bernhard and Leblang, 2002; Mohr and Fourie, 1996; Samuelson and Nordhaus, 1992).

Er2-Confiscation/expropriation The risk of confiscation or expropriation implies the acquisition of privately owned assets by the state. A clear distinction is made between transfer of ownership of existing privately held assets to the state for political and ideological reasons, and the role of government in establishing productive capacity. Nationalization may be attractive to certain politicians and groups of voters or workers who want to increase their power, but nationalization often results in large bureaucracies, inefficiency and political interference (Mohr and Fourie, 1995). Government involvement might also come about as a result of bankruptcy in a major private industry, or government might cite ideological reasons as a factor in the creation of SOEs (Todaro, 1989). Compensation for nationalized foreign enterprises are usually determined by the manner in which the property was acquired in the first place; the historical and replacement costs of the confiscated assets; the nature and record of the enterprise’s relations with the

government and people of the confiscating country prior to confiscation; and the financial benefits and economic returns that have already been reaped prior to the confiscation (Todaro, 1989). As mentioned previously, foreign enterprises that prove to be extremely profitable might actually run the risk of being confiscated due to their financial attractiveness.

Er3-Quality and nature of labour force Although this factor can also be grouped as a political risk factor, it is placed as an economic risk factor due to the loss in profit and financial productivity that might be incurred because of labour instability. It is assumed that a labour force is a group of people 16 years of age and older who are either employed or unemployed, where labour is the exercise of human mental and physical effort in the production of goods and services. The quality of labour is usually linked to the notion of human capital that refers to the skill, knowledge, health, nutrition, and attitude to work of a labour force. It follows that an abundant labour supply results in a high quantity in labour, but not necessarily high quality. Remuneration of labour is affected by factors not directly linked to labour market conditions, like taxation and workers' views as to what constitutes a living wage or a reasonable standard of living.

Factors that affect the labour force participation rate (LFPR) include the age distribution of the population (the greater the proportion of the population in the 16-64 age group, the greater the labour force); retirement rules and the availability of social security (compulsory retirement tends to reduce the LFPR); social, cultural, religious or other conventions about the role of women in society (in a country where women are free or encouraged to work outside the home, the LFPR is higher); the availability of household appliances and childcare centres (enabling women to take up paid employment outside the home); and the level of development and structure of the economy (countries where light industry and services are important will have higher female (and total) LFPRs than countries whose economies are dominated by, for instance, mining and heavy industry) (Kischka et.al.(eds.), 2000; Mohr and Fourie, 1995).

Er4-Domestic economic strength It is assumed that the larger the average disposable income of a household, the larger the role that consumers play in influencing what domestic markets produce, which in turn determines economic strength. If wage increases counterbalance rising inflation, consumerism remains stable, as does the average disposable income. A decline in consumer spending is often seen as an indication of a weakening economy. Economic decline affects material living standards, which can in turn augment an underlying dissatisfaction with government performance, or even cause the blame to be shifted to economically privileged groups.

Er5-Repatriation of profits Higher taxes on corporate profits in developing countries restrict profit-taking, but can be raised disproportionately to corporate activity, exactly due to the fact that there is relatively less overall corporate activity in such countries. The ability of a foreign organization to remit profits back to the home country, and then the agreed upon percentage of repatriable profits, is often a

contentious issue. Investment and Business Codes may allow for unrestricted profit repatriation, but these may not always be applied in practice (Brewer, 1986; Kischka et.al. (eds.), 2000).

Er6-Foreign ownership stake It is assumed that the larger a host country's share in a foreign enterprise, the larger the profit-taking is for the host country. In some host countries, foreign investors agree upon less control of their investment in turn for expeditious government approval of their operation. Where the commencement of an operation is delayed due to local partners stalling the process, the amount of money lost in an unproductive waiting period can hardly be "made back". Countries that allow or acknowledge international arbitration agreements are usually less prone to instigating such delays, and less prone to insisting on more than 50 per cent ownership of foreign enterprises (Mohr and Fourie, 1995).

Er7-Privatisation Privatization implies the prevalence of private ownership of the means of production and the selling of public assets to private business interests, thus facilitating the transfer of ownership and control from the public to the private sector. In some host countries, state owned enterprises (SOEs) are still favoured due to a lack of private incentive to engage in promising economic activities because of uncertainty about the size of local markets, unreliable supply sources, a lack of technology, and a lack of skilled labour. Developing countries might favour privatization initiatives in order to expand employment and facilitate the training of the labour force. They might also be able to increase export earnings by creating export industries (Todaro, 1989). Privatization also enables the financing of increased government expenditure where tax burdens are already very high. Government ownership is often less efficient than private ownership and it follows that the role of the government in an economy should be reduced, creating more scope for private ownership and private initiative. Losses from inefficient SOEs are often a major source of budget deficits and other fiscal problems (Kischka et.al. (eds.), 2000; Mohr and Fourie, 1995).

Er8-GDP The Gross Domestic Product (GDP) of a country, as a measure of production, income, and expenditure, refers to the total output produced inside a country during a given year. This contrasts with Gross National Product (GNP), which is the output produced by factors owned by the country in host countries (Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992).

Er9-Nationalisation of key industries/sectors Direct government control may be required to ensure prices are not set above the cost of producing the output. Goods that have a high social benefit are usually provided at a price below their cost or even for free, thus the private sector has no incentive to compete for the production of such goods. SOEs are often used as initial instruments of capital formation when private savings are very low – based on the rationale that investment breeds further investment. For reasons of income distribution, government may locate enterprises in certain sectors, particularly in "backward" economic areas where

there is little or no private incentive to create economic activity. SOEs are also used as instruments with which to gain national control over strategic sectors of the economy such as defense. Profitability of SOEs is usually low, as they have to pursue both commercial and social goals (goods offered below cost as subsidy, or hiring extra labour to meet national employment objectives) (Todaro, 1989).

Er10-Losses from exchange controls It is assumed that currency depreciation takes place when a country's currency declines in relative value to other foreign currencies (Samuelson and Nordhaus, 1992). This might be profitable for the exporting of goods and services; but foreign operators that have to import machinery essential to their productivity in a host country that is experiencing rapid currency devaluation or a weakening currency will face financial difficulty. In some cases, a currency is so weak that there is no demand for it on the foreign exchange market and local earnings cannot be converted due to a lack of currency buyers. Even where earnings are in US dollars, the repatriation of those earnings are problematic in cases where host governments restrict their repatriation in an effort to "keep them in the country" (Dealmaker, 2002; Samuelson and Nordhaus, 1992).

Er11-Degree of protectionism Any policy adopted by a country to protect domestic industries against competition from imports are protectionist in nature and negate the flow of free trade. Most commonly, prohibitive or non-prohibitive tariffs, quotas or non-tariff barriers (like transport costs and health regulations) are imposed on such imports. Tariffs not based on sound economics include mercantilist ideological underpinnings, tariffs for special interest groups, competition from cheap foreign labour, import relief, and retaliatory tariffs (anti-dumping) (Samuelson and Nordhaus, 1992). Infant industries and SOEs are often protected in this manner and are based on the rationale of economic nationalism and import substitution industrialization (Mohr and Fourie, 1995).

Er12-Role of organized labour Unions affect wages by restricting the labour supply; bargaining for standard rates; following policies designed to shift productivity or the demand schedule for labour upward; and by countering the monopsony and monopoly bargaining power of employers (Samuelson and Nordhaus, 1992). Official trade unions can prove to be a strong political and economic force in especially corporatist-type policy agreements. Indicative of the prominent role of labour union movement in a country can be, for example, former trade union leaders occupying important political offices after an election. Trade unions serve as a countervailing force to the bargaining power of employers – major points of reference in strike action include what other workers are "getting", the employer's ability (and willingness) to pay, changes in the cost of living and overall productivity (Mohr and Fourie, 1995).

Er13-Competitiveness It is assumed that competitiveness is an important feature of an "open economy" or market capitalism, as competition occurs on each side of the market – among suppliers (sellers) and buyers (consumers) on the other.

Competition among sellers protects consumers against exploitation and promotes efficiency and growth. Such competition also creates order among suppliers, as successful competitors are more profitable. But because competition is not always free and fair, interventionist practices and protectionism tends to be the result of inequality and instability (Mohr and Fourie, 1995). Imperfect competition refers to markets in which perfect competition is not possible due to at least one seller or buyer being large enough to affect market prices by monopsony (being the only buyer), oligopoly or monopolistic competition. In such cases, competitive equilibrium can never be reached and is probably not pursued either. There are, however, a multitude of government policies that can encourage competition, including antitrust policies; minimizing the barriers to competition; competition from foreign firms; competitive bidding for contracts; the removal of regulatory or other constraints to competition; and allowing smaller businesses to enter established areas (Samuelson and Nordhaus, 1992).

Er14-Level of government intervention The roles of SOEs have been mentioned before, as have the measures of privatization, nationalization and competitiveness. Government intervention can also include the activity of government buying or selling its currency on the foreign exchange markets in order to affect its currency's exchange rate (Samuelson and Nordhaus, 1992). Government might justifiably intervene economically in order to keep the prices of basic foodstuffs low as part of a policy to assist the poor, to avoid the exploitation of consumers by producers, or to avoid "unfair" prices and to combat inflation (Mohr and Fourie, 1995). High levels of government intervention and centralized planning point toward a certain type of state system and government organization and stands in complete contradiction to *laissez-faire* practices.

Er15-Economic impact of HIV/AIDS Labour is an important factor of production in any country and for any foreign investor. It has also been explained that the health of a labour force directly impacts upon and contributes to the quality of a labour force, and thus directly impacts upon its levels of productivity. It follows that the destabilizing effect that HIV/AIDS will have on labour forces, productivity, economies, and profitability is highly significant and an unavoidable given. Government policy toward the pandemic in terms of expenditure as well as welfare and health policy, including economic contingency plans and strategy, also indicates the degree of government responsibility, commitment, and political will to deal with the realities of the issue, and the quality and nature of government policies (Ostergard, 2002).

Er16-Efficient banking system The competency of a Central Bank or Reserve Bank, as well as the competency of commercial and savings banks, are an indication of the efficiency of a country's banking system and functional financial sector. A Central Bank is an institution established by government, responsible for controlling a country's money supply and credit conditions, and for supervising the financial system – especially commercial banks. A commercial bank acts as a financial intermediary between individuals and companies on the one hand, and the

Central Bank on the other. A Central Bank is, among other things, responsible for the formulation and implementation of monetary policy; and as the monetary authority, issues money, acts as a "banker's bank", as a banker for government, and acts as a custodian of a country's gold and other foreign reserves (Mohr and Fourie, 1995; Todaro, 1989). Commercial banks hold savings or fixed (time) deposit and money market deposit accounts, sell traveler's cheques, and perform other financial services like lending to individuals, firms and even countries (Samuelson and Nordhaus, 1992). Financial institutions in many developing countries are highly unorganized, and are often externally dependent and spatially fragmented. The ability of these governments to regulate the national supply of money is further constrained by the openness of their economies, and by the fact that the accumulation of foreign currency earnings is a significant but highly variable source of domestic financial resources (Bernard and Leblang, 2002; Todaro, 1989).

Er17-Confidence in the finance ministry It is assumed that high levels of domestic and international levels of confidence in a country's finance ministry is an indication of high levels of domestic and international confidence in a country's macroeconomic and fiscal policy. Even better though, are cases in which such confidence is concomitant to policy penetration and execution and the reaching of realistically set goals. Ministerial flexibility, competence, and agility are also tested in cases where policy that was not necessarily faulty but was still ineffective, was adapted in order to remedy ineffective policy.

Er18-Real interest rate The interest rate is the price paid for borrowing money for a period of time, usually expressed as a percentage of the principal per year – in other words, an interest rate is the *cost* of borrowing money. The real interest rate is the nominal interest rate less the rate of inflation, and shows signs of increase if monetary policy is tightened in reaction to a high inflation rate (Samuelson and Nordhaus, 1992). It is assumed that higher interest rates will discourage the borrowing of money and encourage saving and investment, but in developing countries investment decisions are often not very sensitive to interest rate movements (Todaro, 1989).

Er19-MIGA signatory and FDI As a signatory of this agreement, a host country indicates the ability as well as the willingness for international compliance. As a debtor nation, being a MIGA signatory lends creditworthiness (Brewer, 1986).

Er20-Sound physical infrastructure A healthy and growing infrastructure usually indicates possibilities and a base for further capital accumulation. New factories, machinery, equipment, and materials increase the physical "capital stock" of a nation and make it possible for expanded output levels to be achieved. These directly productive investments are supplemented by investments in what is often called social and economic infrastructure such as roads, electricity, water and sanitation supply, as well as in communications which facilitate and integrate economic activities (Todaro, 1989). This might indicate high and expansive levels

of taxation though, raised in order to finance the development and maintenance of such infrastructure.

Er21-Economic growth rate The economic growth rate reflects the increase (and decrease or stagnation) in the total output of a nation over time, and is usually measured as the annual rate of increase in a country's real GNP (Samuelson and Nordhaus, 1992). A country's factors of production, as well as growth in efficiency are of importance in reflecting the growth rate. Although one expects economic growth to be coupled with higher levels of employment, "jobless growth" is possible despite economic expansion. In this instance, an increase in production takes place without an accompanying increase in employment.

Er22-Annual average inflation rate Effects of inflation are a redistribution of income and wealth among different classes; and distortions in the relative prices and outputs of different goods, or in output and employment for an economy as a whole. Inflation affects income and assets, randomly redistributing wealth around the population with little significant impact on any single group (unlike taxation). Unanticipated rises in inflation redistributes wealth from creditors to debtors (favouring those who have borrowed money), while an unanticipated decline in inflation has the opposite effect (favouring those who have lent money). Because of the "costs" of inflation, its containment is one of the prime targets of a government's macroeconomic policy – unbalanced inflation distorts relative prices, tax rates, and real interest rates (Kischka et.al.(eds.), 2000; Samuelson and Nordhaus, 1992).

Er23-Economically active population Some inherent factors are included in measurements of the economically active population as a means of production. Population growth and disease should be controlled, and health and nutrition improved in order to enable workers to be more productive, and to prevent a loss in man-hours due to sick leave or lengthy hospital visits. Workers' education should be improved, their rate of illiteracy reduced, and their skills level raised, as educated people become more productive workers who can use capital more effectively, adopt new technologies, and learn from mistakes (Samuelson and Nordhaus, 1992). Signs of a "brain drain" indicate symptoms of skilled members of the labour force having exhausted their efforts within a home economy.

Er24-Change in real wages Where a nominal wage is the amount of money actually received by a worker per hour, day, month or year, the *real* wage is the quantity of goods and services that can be purchased with the nominal or money wage. A higher inflation rate without a relative rise in real wages, impacts negatively on the amount of goods and services that a worker can purchase (Mohr and Fourie, 1995).

Er25-Price index The consumer price index (CPI) is an index or reflection of the prices of a representative "basket" of consumer goods and services. The CPI thus represents the cost of the "shopping basket" of goods and services of a typical

household (Bunge, 1998; Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992). A rise in the inflation rate will result in the same basket of goods and services costing more, or in a consumer being able to purchase less goods and services for the same amount of money. The inflation rate is measured by the annual percentage change in the CPI. Although a drop in inflation is always welcome, a stable rate of inflation is less worrying than a rapid increase or uncontrollable rise in inflation. This implies that inflation can be uncontrolled, where government is not fighting inflation due to a lack of resources, little political will or little competence.

Er26-Balance of payments The trade account is the part of a country's balance of payments that deals with merchandise or visible imports and exports. When services (invisibles) are included, the total accounting for imports and exports of goods and services is called the balance on the current account (Samuelson and Nordhaus, 1992). A surplus on the current account indicates a net inflow of foreign capital into a country, whereas a deficit could indicate a net outflow of capital due to, for instance, divestiture or financial sanctions (Mohr and Fourie, 1995; Venter, 1999).

Er27-Discrimination against foreign business It is assumed that measuring the degree of discrimination against foreign business in a host country, is reflective of among other things, a country's general investment climate.

Er28-Adequacy of international reserves A country generally has adequate international reserves in its balance of payments if an economy can sustain itself for at least three months (ideally more), should all factors of production come to an abrupt halt.

Er29-Debt service burden and foreign aid Whereas government inability to repay foreign debt is a credit risk, a government's unwillingness to repay debt is a political risk. In developing countries, government expenditure in terms of welfare, health, education, infrastructure and poverty relief programmes place enough of a burden on an already strained budget. In some cases, the interest on foreign loans can hardly be serviced, and the percentage of GDP used to repay loans outweighs public expenditure and percentage growth in the GDP. A country's debt service ratio as a percentage of exports, is calculated as the year's sum of interest and principal repayments on external public and publicly guaranteed debt as a percentage of exports of goods and services (Bradley and Schaefer, 1998; Clegg, Ibarra-Colado and Bueno-Rodriguez, 1999; Coplin and O'Leary, 1998; Venter, 1999). High debt burdens negatively affect social investments, and can fuel popular unrest and other preconditions of conflict.

Er30-Preservation of resources A country's potential for economic growth as well as its economic prospects are greatly influenced by its physical resource endowment and consequently the protection thereof. Government regulations and policy should control harmful externalities like air and water pollution; strip

mining, hazardous wastes, unsafe drugs and foods, and radioactive materials. Apart from threatening the health of the workforce, which is a valuable factor of production, the sustainability of physical resources, another factor of production, is also threatened (Beckman, 2002; Samuelson and Nordhaus, 1992; Todaro, 1989).

The unregulated depletion of resources can constrain economic growth and productivity, and cause poverty and migration which underlie social and political instability. Scarcities in resources can result in an increased demand for such resources and/or the unequal distribution of these resources, while the rules of distribution might also suddenly change.

Er31-Deforestation rate Attention has previously been drawn to the necessity of preserving natural resources as an exhaustible factor of production. One reason for negative growth of per capita food production in developing countries includes insufficient and inappropriate innovation; cultivation of marginal and sensitive lands; severe deforestation and erosion without reforestation; and misguided pricing and marketing policies (Todaro, 1989).

Er32-Carbon dioxide emissions Interestingly enough, it is rather free market economies that “need” these regulations. In addition, population becomes a problem in relation to the availability and utilization of scarce natural and material resources. It has been argued that industrialized nations should curtail their excessive consumption of natural resources, instead of asking less developed nations to control population growth (Samuelson and Nordhaus, 1992; Todaro, 1989).

Er33-Trade issues and terms of trade Terms of trade (international trade), reflects the “real” terms at which a nation sells its export products and buys its import products. It equals the ratio of an index of export prices to an index of import prices. It can be argued that trade tariffs have true economic merit if tariffs move the terms of trade in favour of a (developing) country, already suffering structural difficulty. If terms of trade deteriorate, it could be due to imports rising faster than exports, or because export prices have fallen faster than import prices. This can lead to a decrease in real income growth, or to actual economic decline (Evans and Newnham, 1992; Samuelson and Nordhaus, 1989). Low levels of involvement in international trade is associated with higher political risk, in the sense that the conditions that inhibit high trade levels and foreign investment (for instance corruption and poor infrastructure) increase a probability of political crisis.

Er34-Unemployment rate A decline in economic growth can contribute to an increase in unemployment. In an industrialized country, a 3 per cent rise in unemployment can have a much more disastrous shock effect than the same rise in a developing country, where it might be seen as “par for the course”. Creating jobs for a growing population is also a concern for developing countries and job creation initiatives often demand large amounts of government expenditure, notwithstanding poverty relief, health and welfare programmes. High and sustained unemployment rates often indicate the possibility of a large and growing

informal economy or sector – where individuals do not pay tax, cannot find employment in the formal sector, and are often engaged in illegal activities. Measurements of unemployment could be taken on aggregate, as members of the economically active population can either be underemployed, or become involuntary, voluntary, frictionally, seasonally, structurally or cyclically unemployed as opposed to being “gainfully employed” (Clegg, Ibarra-Colado and Bueno-Rodriguez, 1999; Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992).

Er35-Loan default/unfavourable loan restructuring Where loan default is a result of a country's inability to repay loans, credit risk comes to the fore. This is opposed to loan default due to sovereign risk, or an unwillingness to repay loans despite an ability to do so. SAPs are mechanisms conditional to IMF loans, bailouts or support that euphemistically suggests shifts in macroeconomic and often political policy within a debtor country. *Dependencia* theorists have put forward arguments for the scrapping of “Third World debt”, arguing that the debt burden on developing countries prohibits any other form of government expenditure aimed at economic and social development – the logic is that, once the debt has been scrapped, developing countries can start socio-economic upliftment programmes with a clean slate, rid of the debt-backlash (Todaro, 1989). The other side of the argument states that it is not the debt burden holding developing countries back, but rather a domestic inability to conduct macroeconomic management. Loan restructuring is a point of contention at many IMF conferences and is often used as a bargaining chip.

Er36-Government expenditure Government spending is essentially a political issue and is related to political objectives rather than to the level of income. There is often pressure on government to spend more on education, housing, health, and on safety and security, than on defense. Government's instruments of fiscal policy and economic activity involves three important flows, namely government expenditure on goods and services; taxes levied on (and paid by) households and firms; and transfer payments or the transfer of income and expenditure from certain individuals and groups to other individuals and groups (the poor) (Kischka et.al. (eds.), 2000; Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992).

Er37-Macroeconomic policy Macroeconomics focuses on, among other factors, aggregate economic behaviour and performance of the economy regarding output, income, the price level, foreign trade, and unemployment. Economic production, income, and spending are features that are interdependent in an economic system. The organization of those interdependent links, as well as their (un)successful management by government, are often reflections of (un)sound macroeconomic policy. Steps taken to reduce inflation for instance, include restraining the growth of real output and raising unemployment, or by putting controls on prices and wages. Where the result thereof is a period of stagnation, government has to convince the public of its responsible governance. With rational expectations and flexible prices and wages, anticipated government policy cannot affect real output or unemployment. A country's macroeconomic goals can be reached by effective

policy on expenditure and taxation (fiscal policy); monetary concerns; foreign economic activities; and incomes policies (Bunge, 1998; Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992; Todaro, 1989; Venter, 1999).

Er38-Financial sector supervision One such supervisory practice includes fractional-reserve banking, a regulation whereby financial institutions are legally required to keep a specified fraction of their deposits in the form of deposits with the central bank (or in vault cash). A benchmark average would be a requisite of 12 per cent of checking deposits in reserves. By imposing high fixed legal reserve requirements, government can better control the money supply (Harms, 2002; Samuelson and Nordhaus, 1992).

Er39-Vulnerability spread In cases where a country is a “single commodity exporter”, its degree of vulnerability is relatively high not only regarding changes in exchange rates or market prices, but also in the sense of climatic vulnerability. If dependent on a single crop export, a cyclical storm can destroy an annual harvest and directly impact upon potential earnings from such a crop (like tobacco, corn, pepper, vanilla, coffee). Another factor is urbanization – where a country is dependent on the agricultural sector for export earnings, the depopulation of rural areas and migration toward urban areas impacts negatively on agricultural production. Ideally, the production of goods and services in a country occurs in the primary sector (where raw materials such as agricultural, fishing, forestry, and mining products are produced), secondary sector (the manufacturing sector where raw materials and other inputs are used to produce other goods), and the tertiary sector (comprised of the services and trade sections of the economy). Ironically, many countries export raw materials, only to have to import manufactured products from other countries made by using the same raw materials exported in the first place (Carley, 1981; Mohr and Fourie, 1995).

Er40-Stability and ability of central banks Although the role(s) of central banks have already been mentioned, the management thereof is also an important issue. Government ability and competence of government officials are directly related to government performance, policy formulation and output. In the same way, the management team of a central bank has to be experienced, competent, and flexible in order to conduct sound monetary management and to adapt crisis management policy where necessary.

Er41-Fiscal prudence It is assumed that this also acts as a reflection of a country’s governance ability and competence. Compliance with international standards also raises levels of domestic and international trust in the finance ministry and the regulation of the fiscal sector. Notwithstanding rules, laws, supervisory and regulatory practices being in place, these still need to be enforced with accountable oversight (Samuelson and Nordhaus, 1992).

Social factors of political risk

Sr1-Government investment in human capital Human capital is the stock of technical knowledge and skill embodied in a nation's workforce, resulting from investments in formal education and on-the-job training (Bunge, 1998; Samuelson and Nordhaus, 1992). The quality of a country's labour force is almost more important than the quantity of labour. The quality of labour is usually described as "human capital" which refers to the skill, knowledge, and health of a workforce. Education, training and experience are all determinants of human capital (Mohr and Fourie, 1995). Cultural outlooks, attitudes toward work as well as a desire for self-improvement also contribute toward the quality of human capital in a country. The nature and character of a country's human resources (culture, tradition, religions, ethnic and tribal fragmentation) are important determinants of its economic structure and differ not only among countries, but within them as well. Investment in human resources can improve the quality of a labour force and thereby have the same, if not a more powerful, effect on economic production as an increase in physical quantity. Formal schooling, vocational and on-the-job training programs, as well as adult and other types of "informal"– training and education may be more effective in developing human skills and resources as a result of direct investments in buildings, equipment, and materials (like books, computers, science equipment). The concept of investment in human capital is associated with improving the quality and thus productivity of a workforce and economy (Todaro, 1989).

Sr2-(II)Literacy rate The quality of education is a problem in many developing countries, and the assumption is that there is a positive correlation between educational quality in a country and the quality of human capital. In education, low levels of literacy, significant school dropout rates, and inadequate and often irrelevant educational curricula and facilities are often the case. In this case, literacy does not simply refer to alphabetical literacy, but to numerical literacy as well. The quality of scientific and mathematical skills in a developing country's workforce is often quite low. In some cases this is not only due to the quality of education, but also to a "brain-drain" phenomenon (Shonfield and Shaw, 1972; Todaro, 1989).

Sr3-Job mobility impediments The assumption is that the higher the level or degree of job mobility impediment, the bigger the chance that demands for appropriate employment might occur. It follows that within a country, the higher the degree of job mobility impediment, the more chance there is of a significant "brain-drain" of skilled labour in the form of technicians, medical professionals, scientists and engineers among other highly trained individuals taking place. Young, unemployed individuals can be politically volatile and prone to violence as a resort. Such individuals often have little trust in political institutions and patterns of authority.

Sr4-Gini coefficient The Gini coefficient acts as an aggregate numerical measure of income inequality within a country ranging from zero (perfect equality) to one per cent (perfect inequality). It follows that the higher the value of the coefficient, the higher the inequality of income distribution. It can be assumed that sentiments relating to relative deprivation can be manifested in crime statistics, among other figures pertaining to the socio-economic climate and circumstances of a country. Income inequality indicates the existence of a disproportionate distribution of total national income among households, whereby the share going to the "rich" in a country are far greater than that going to the "poor". This can however, largely be due to differences in the amount of income derived from ownership of property and to a lesser extent the result of differences in earned income.

The significance of such a measurement for foreign investment lies therein that the higher the coefficient, the greater the chance that government may try to remedy this by imposing wealth taxes, higher corporate taxes and steeply progressive income practices (Kischka et.al. (eds.), 2000; Todaro, 1989). Economic growth is also probably reliant on the means and effort of a wealthy minority, with the majority of a population placing more of a burden on growth. It is assumed that the higher the Gini coefficient in a country with an open free market capitalist system (as opposed to a socialist system where income equality is contrived), the more sluggish growth might be. High levels of economic inequality can contribute to social fragmentation and declining legitimacy of government.

Sr5-Education ratio – student:teacher The assumption is that the lower the student:teacher ratio, the more intensive schooling is in terms of time and effort, as well as the amount of attention given to individual learners. This might contribute to higher education quality as smaller classes probably also enjoy abundant resources (like books and materials). School fees might be higher though, but it is assumed that a lower ratio contributes to higher educational quality, higher levels of investment in human capital, and eventually a better quality workforce (Todaro, 1989).

Sr6-Per capita income Income per capita is calculated by either dividing the total GNP of a country by the total population (the atlas method), or by measuring the per capita purchasing power parity (PPP). Per capita income is often used as an economic indicator of the quality of life and levels of development. However, it can be biased in the sense that it does not take into account income distribution and the ownership of the assets that are employed to generate part of that income. The assumption is that the higher the per capita income, the larger disposable income is (correlated to a market for consumer spending), and the higher the level of living (Mohr and Fourie, 1995; Todaro, 1989).

Sr7-Mean period of schooling Employers tend to select employees by level of education when faced with an excess of applicants. It is assumed that the longer the mean period of schooling is in a country, the higher the quality of human capital in the labour force. A country with high dropout rates probably has a workforce with lower levels of human capital quality. In addition to "manpower

planning” needs, the public can also exert tremendous political pressure for the expansion of school places (not only in primary schools) in developing countries. Government expenditure on education in many cases is relatively high, but becomes problematic when high levels of expenditure are not coupled with high levels of competence in the management of education policy effectiveness. The proposition that educational expansion promotes and probably determines the rate of overall GNP growth is unquestioned. The expansion of educational opportunities contributes to aggregate economic growth by creating a more productive labour force; by providing income-earning opportunities for teachers and related industries (printers, uniform manufacturers); and by creating educated leaders (Todaro, 1989).

Sr8-Unemployment rate It is assumed that individuals who are willing and able to work but do not have jobs, are unemployed in the formal economy. The number of unemployed people can be expressed as a percentage of the total number of people who are willing and able to work in the formal economy, not including the underemployed. It is assumed that the higher the unemployment rate the lower levels of living are, and the more inefficient or inadequate the utilization of labour is within a certain country. Coupled to population growth and as labour supply expands, jobs will have to be created at an equivalent pace and the GDP should grow relative to these rates. Prospects for dealing with frustrated, anxious and increasingly vocal, educated, yet unemployed people are worrisome. But unemployment problems in developing countries have much more complex causes than in industrialized countries, and are more difficult to solve – even more so if leadership and policy is inadequate and overwhelmed. High rates of unemployment are often linked to high crime rates as well (Harms, 2002; Kischka et.al.(eds.), 2000; Mohr and Fourie, 1995; Todaro, 1989).

Sr9-Attitude toward foreign businesspeople and visitors Attitude toward foreign business people or visitors also acts as an indication of tolerance within the investment climate, as well as the openness of the political system as a whole.

Sr10-Acceptable quality of life There is a positive correlation between the level of education and per capita income, and an individual's quality of life. What further contributes to quality of life are low crime levels and easy access to the provision of government or public services like safe drinking water, electricity, health services and hospitals, emergency services, pharmaceuticals, welfare services, education, and training. It is also assumed that life expectancy is positively correlated to quality of life – the higher life expectancy is, the higher the quality of life seems to be. In developing countries, climate and disease detract from the quality of life and life expectancy has been dealt a serious blow by TB, malaria, cholera, starvation and HIV/AIDS (Carley, 1981; Daily Mail and Guardian, 31 May 2002; Kischka et.al. (eds.), 2000).

Sr11-Urbanisation rate Apart from limited access to the commercial agricultural sector in many developing countries, impoverished subsistence farmers and other

parts of rural populations are migrating to urban centres of economic activity in hope of “a better life”. Opportunities for earning wages and higher incomes in urban areas are attracting often uncontrollable amounts of people. Informal settlements around urban areas are growing rapidly and the quality of life in such settlements is poor (Carley, 1981). This is often due to government not being able to render the necessary services to people in such areas as a result of sheer numbers and expense. Municipal services are overtaxed and the burden placed on the state is not only manifested in an over-supply of labour, but in an over-supply of the needy. Government actions to curb hyper-urbanization can include creating an appropriate rural-urban economic balance, the expansion of small-scale labour-intensive industries, the elimination of factor-price distortions and an expanded provision of family planning and rural health services (Carley, 1981; Todaro, 1989; Venter, 1999).

Sr12-Population The correlation between population growth, economic growth, and unemployment has already been mentioned, but a negative population growth can have a disadvantageous effect on a country. If a population is ageing, the social welfare burden on the state to raise revenue for pension payouts increases. An ageing population also correlates negatively with not only the quality, but also the actual size of the labour force. Many developing countries find it increasingly difficult to supply basic services to a rapidly growing population, and problems with distributing these resources also contribute to rapid urbanization trends. Although the developing world comprises more than three-quarters of the global population, the rate of consumption of resources is far higher in industrialized countries than in developing countries (Carley, 1981; Fullbrook, 2000; Venter, 1999).⁵ High population growth rates and density can augment the probability of political risk occurring due to increased competition for physical and social resources.

Sr13-Average calorie intake and nutrition As an indicator of the overall rate of human development, the average calorie intake of individuals within a country also points toward the quality of life (Carley, 1981), health, and life expectancy of especially infants, notwithstanding the overall quality of human capital and the labour force in general. Being able to provide food for individuals is one of the most basic responsibilities of government – an inability to do so points toward resource distribution problems and can result in questionable government legitimacy. In some cases populations face starvation as a direct result of political management.

Sr14-Health care Health care also acts as an indicator of government’s ability to provide, manage, and distribute resources within a country. Factors that can influence the doctor:patient:nurse ratio for instance are population growth, number of facilities, and a “brain-drain”. Many man-hours are often lost due to workers having to make laborious trips to clinics, doctors, or hospitals that are difficult to reach (physically by vehicle or on foot), or because “better quality” facilities are mostly situated in urban areas. Government health care policy is also an indication

of overall government performance, accountability, and responsibility. Unrealistic government policy toward HIV/AIDS for example, prompts questions about the quality, nature and rationale of decision making in a country, both from domestic as well as international parties.

Sr15-Life expectancy As a measure of overall quality of life in a country, life expectancy also measures the effectiveness of a government's health policy and the enforcement thereof as well as the management of "common-good" health resources like state hospitals (Carley, 1981). The availability of medicines and pharmaceuticals are also inherent in these risk factor indicators of the overall quality of human capital of a country.

Sr16-Infant mortality rate In terms of deaths related to malaria and cholera, climate plays a large role in infant mortality. But the infant mortality rate is also an indicator of overall human development and a government's ability to raise the quality of life, life expectancy and the overall quality of human capital (Carley, 1981).

Sr17-Telephone communication and ICT It is assumed that the frequencies of telephones per 1000 people will differ in urban and rural areas. Nevertheless, the number of telephones per person is taken to be a measure of the number of telephone lines (assuming that each line has a telephonic instrument). The ratio of telephones:people is a useful measurement as an indicator of technological development and the *potential* for technological development (Bunge, 1998). One can go further and extrapolate the potential number of Internet users, the size of the industry surrounding the use of landlines, fiber optics, the Internet Service Providers, and cellular phones. Related industries can involve telecom providers, hardware (computers, advanced telephone systems) and software providers, network providers, as well as cellular phone service providers. It might not even be that far-fetched to assume that people making use of these services might in all probability also own television sets (<http://www.undp.org/hdro>).

Sr18-Population access rates This correlates to government ability to provide basic and advanced services, and the mentioned distribution of resources that, if ineffective, can probably lead to rapid urbanization and even possible legitimacy problems for government (Carley, 1981). A lack of or decline in public services such as health services, education, safe water, and sanitation point toward a state's weak capacity to distribute and allocate vital services. What usually follows is a decrease in popular confidence in government, which can lead to social unrest and political instability.

Sr19-Provision of public services A large part of government expenditure is usually (or should be) spent on the provision of basic municipal and public services. Where the public is taxed in order to finance the provision of such services, it is quite understandable that individuals would expect to see the effect of the provision thereof. Where payments of rates and taxes are halted in order to

show discontent in the quality of services, measures of public consent can point to disapproval of political policy, of government management, or governance as such. It is assumed that high taxes should correlate with high level government performance and quality services. The provision of safety and security services is an extremely important measurement of government policy objectives. An ineffective and demoralized police service is in most cases the result of very poor salaries and wages. The “closing down” of crime prevention units like that of child protection, for instance, is an unfortunate indicator of weak overall government performance.

Sr20-Global human development rating (HDI) A country’s human development rating is indicative of life expectancy, quality of life, level of education, access to services, and overall quality of human development, as well as the quality of the labour force (Carley, 1981). It can also be indicative of a government’s performance in realizing efforts made at raising a country’s level of human development and the effectiveness of development policy and initiatives. The eventual relation between political and governmental efforts at raising overall human development in a country, and the eventual HDI reading, can result in government accounting for the discrepancy between theory and practice, even the misappropriation of funds set aside for development projects as opposed to mere incompetence in managing such projects (<http://lib.stat.cmu.edu/datasets/humandevol>).

Sr21-Daily newspapers The newspapers:people ratio is among other things, indicative of the status of the media. It is assumed that the larger the variety of newspapers in a variety of languages within a country, and the more autonomous these papers are, the higher the levels of media freedom are. The harassment and imprisonment of journalists and editors critical of a government is, of course, also an indication of government tolerance toward criticism and the status of media freedom. Industries relating to the media are the printing industry and advertising industry, and the more demand there is for media, the more journalists find employment. One can also assume that those purchasing a newspaper are literate, leading one to believe that the demand for printed media correlates with the literacy rate of a country. It can further be assumed that the demand for media indicates a desire for information, knowledge and empowerment, and that an informed public is a less ignorant public (<http://www.undp.org/hdro>).

Sr22-Radio and television Most of what has been mentioned regarding telephones and newspapers also applies to the radio:people ratio. Yet one should be aware of the fact that individuals might purchase radios because they are unable to read – due to illiteracy or impaired vision. Radios are also much cheaper than television sets and operating a radio does not presuppose access to electricity. The assumption is that listening to news reports on a radio contributes to new-learning and acquired information. Radios imply that there are radio stations that employ both trained and unskilled workers, sell and buy airtime, and probably encourage local musicians and artists to develop material.

Sr23-Social consciousness and conscience of government Previous discussions have dealt with the factors that contribute to high or low levels of human capital quite extensively. However, the social consciousness of government also relates to the level of arts and culture in a country and to a society in which there is a demand for both performing and visual arts. In many countries with pressing social upliftment and welfare issues, subsidies and expenditure on arts and culture (keeping theatres operational as well as teaching performing and visual arts) is in drastic decline. This is quite ironic as, due to high illiteracy rates in developing countries, theatre is for example often an effective way of delivering educational messages relating to health, education, and the prevention of crime. Apart from this, the social consciousness of government reaches as far as human rights issues, provision for the elderly, animal protection legislation and animal welfare, environmental protection (of both fauna and flora), cultural and ethnic bias, genocide, and even infanticide. Expenditure on orphanages (especially HIV/AIDS orphans) and hospices, where there is both an ability and willingness to spend, also relates to levels of government social conscience and consciousness.

Sr24-Societal uprising Some societies are less complacent and more mobile when it comes to demonstrating discontent with government policy or action. Bunge (1998) explains that a vigorous populist movement engages in a society if the society faces extremely serious social issues; the ruling classes and traditional political parties are unable or unwilling to address these issues so that large popular groups feel alienated from them and even the state; and if the movement is headed by a charismatic manipulator of public opinion. Demonstrations aimed at MNCs are often the result of job-cuts or wage related issues. But a growing trend in organized international interest groups and in some cases pressure groups, is on the rise.

Sr25-Climate It is a historical fact that almost every successful example of modern economic growth has occurred in a temperate-zone country (Todaro, 1989). The extremes of heat and humidity in many countries contribute to deteriorating soil qualities and the rapid depreciation of many natural goods. These conditions also contribute to the low productivity of certain crops, the weakened regenerative growth of forests, and the poor health of livestock and of human beings. Extreme heat and humidity also cause discomfort to workers and weaken their health, reducing their desire to engage in strenuous physical work, and generally resulting in lower levels of productivity and efficiency (Todaro, 1989).

Concluding Remarks

In this chapter the political, economic, and social risk factor indicators that were used in designing the model that is offered in the next chapter were presented. In order to weigh the indicators though, it is necessary to show what it was that the model intends to measure. Now that the choice of each particular risk factor and

its indicators have been explained, the next chapter will clarify each factor's significance, as well as what it is each factor indicator points toward. In explaining each political risk factor, it is hoped that some guidance is given when rating these risk factor indicators in the model.

This chapter hopefully also served as an illustration of the interrelatedness of political, social and economic phenomena in any country – that these can hardly be separated from one another. The factors that were chosen originate not only in political events and financial economic statistics, but also in the socio-cultural characteristics of different countries, their various histories and trends, as well as their positions in current global events.

The next chapter expands further on the operationalization of this modelling endeavour and illustrates how the fourth chapter was the point of departure for the model itself. Chapter 5 presents the model for political risk analysis that can either be used in a generic macro-type analysis, or for the purposes of client, industry, and business specific analyses.

Notes

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- 1 Although the value “1” could be a point of departure, it is assumed that “0” is applicable in cases where a risk factor indicator is not relevant to a certain case.
 - 2 See *Database of Political Institutions (DPI)* at <http://www.ideas.uqam.ca/data/Papers/wopwobago2283.html>; *Political Regime Characteristics and Transitions, 1800-1999* at <http://www.bsos.umd.edu/cidcm/inscr/polity>; *Freedom in the World Country Ratings 1972/73 to 2000/01* at <http://www.freedomhouse.org/ratings/>; and *Governance Matters II – Updated Governance Indicators for 2000/2001* at <http://www.worldbank.org/wbi/governance/pubs/govmatters2001.htm>.
 - 3 Private consultation with Philip Nel, 14 October 2002.
 - 4 Cases where the motivations for choosing these factors and indicators do not have text references are based on subjective assumptions.
 - 5 In 2002, Steps taken by the government of Singapore to increase birth rates includes offering a bonus of \$300 for a second child.

Chapter 5

Presenting a Model for Political Risk Analysis

This chapter presents the scoring guidelines, weights, mathematics and calculations behind the model for political risk analysis. In consultation with a potential client, the political risk analyst and client decide on the most relevant and applicable risk factors from the generic model. This increases client ownership of the political risk analysis process.

The Mathematics of the Model

The value representing the *real percentage probability* that risk might occur by using weighted value(s), is deemed more reflective and more representative than for instance an average probability.

A further assumption that this book offers is that the mathematical formulae as well as the measurement scale¹ that is developed can be representative of a probability that political risk will impact negatively on firm profitability. However, this should raise questions regarding the theory of probability² and the mathematics of large numbers.³

The problem with political risk and the theory of large numbers lies therein that events are not “fair” in their occurrence – there is neither an even chance nor a large number of comparable events that can be calculated in any given situation. Also, as mentioned in Chapter 2, political risk is not a real definition, but nominal in nature. Political risk as such is rather a metaphor than an actuality that can be calculated in terms of probability theory, and the book is aware of this. One cannot have a frequency distribution of political risk events with a normal distribution curve⁴ and read off from this curve the probability that an event will occur. In political risk, terms such as *likelihood*, *chances* and *probability* are judgments rather than mathematical calculations. The model presented in this book however, still contends that one can make the degree or impact that political risk(s) might have more “tangible”, and can in turn be used to make a judgment about the probability of risk occurring based on the result of the analysis.

Weights attributed to the political, economic and social factors

For purposes of this example, the sum of political risk factors and their indicators are weighted as 50% of the *real* percentage probability that political risk might occur; economic risk factor indicators weigh 30%; and social risk factor indicators 20%.

These weights are flexible and a client or investor using the model can choose to have economic risk factor indicators weigh 40% or even 50% for instance, according to the importance an investor attaches to these risk factor indicators. Factors and indicators can either be added or omitted in the case of a micro-type, client-specific analysis.

A key to the symbols

The symbols are explained as follows:

Pr(1-37) = The sum of political risk factor indicators as weighted by the analyst or rater

Er(1-41) = The sum of economic risk factor indicators as weighted by the analyst or rater

Sr(1-25) = The sum of social risk factor indicators as weighted by the analyst or rater

TotalPr = The sum of the included weighted political risk factor indicators

TotalEr = The sum of the included weighted economic risk factor indicators

TotalSr = The sum of the included weighted social risk factor indicators

Real percentage probability that political risk might occur

In the first instance, the real percentage probability that political risk might occur is calculated as follows:

$$\left\{ \left(\frac{\text{Pr}(1-37)}{\text{Total Pr}} \right) \left[\frac{1}{2} \right] \right\} + \left\{ \left(\frac{\text{Er}(1-41)}{\text{Total Er}} \right) \left[\frac{1}{3} \right] \right\} + \left\{ \left(\frac{\text{Sr}(1-25)}{\text{Total Sr}} \right) \left[\frac{1}{5} \right] \right\} \left(\frac{100}{1} \right)$$

In the second instance, the real percentage probability that political risk might occur is calculated as follows:

$$\left(\left(\frac{\text{Pr}(1-37)}{\text{Total Pr}} \right) \left[\frac{1}{2} \right] \right) \left(\frac{100}{1} \right) + \left(\left(\frac{\text{Er}(1-41)}{\text{Total Er}} \right) \left[\frac{1}{3} \right] \right) \left(\frac{100}{1} \right) + \left(\left(\frac{\text{Sr}(1-25)}{\text{Total Sr}} \right) \left[\frac{1}{5} \right] \right) \left(\frac{100}{1} \right)$$

The scaled percentages

Although a percentage as the “size” of the probability that political risk might impact negatively on a foreign investment is quite self-explanatory, the percentages can also be scaled in addition to the calculated figure. The percentages of chance that political risk might occur can thus be scaled in the following manner:

Table 5.1 Incremental risk scale for investment

Percentage Chance that Political Risk Might Occur	Incremental Scale	Risk Indication
0%-10%	Highly Advisable	LOW RISK
11%-20%	Advisable	
21%-30%	Very Low Risk	
31%-40%	Relatively Low Risk	MODERATE RISK
41%-50%	Low to Moderate Risk	
51%-60%	Relatively Moderate Risk	
61%-70%	Moderate to High Risk	HIGH RISK
71%-80%	Relatively High Risk	
81%-90%	Unadvisable	
91%-100%	Highly Unadvisable	

The Model for Political Risk Analysis

In this section, the model proposed for use as a “tool” for the analysis of political risk is presented. The analyst or rater literally attributes a value to each risk factor indicator. This model is unidimensional in the sense that although economic and social risk factors are also included as political risk factors, all risk factors and their indicators included in the model measure the single construct of political risk (Neuman, 2000).

The correlations have been designed to imply that the higher a rating is of a certain risk factor, the larger that risk factor’s contribution will be to the eventual percentage probability that political risk might occur. Each individual using the model and rating the factor indicators attributes a value to each indicator on the indicated scale.⁵ For example, in *Er27-Discrimination against foreign business*: To what extent do bureaucratic delays purposefully keep foreign investors out of the market (*Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20*). An individual that perceives such delays as a lesser influence can attribute a value to the factor indicator on a scale from 0 to 10 – where 0 would be no extent at all and 10 the highest rating of a “lesser extent”.

In some cases, for example in *Pr1-Political system*, only one option can be chosen, but the ratings have been designed in such a way as to accommodate the

value attributed to the indicators of the risk factor *Pr1 – Political system*. A one-party dominant democracy will rate “higher” than, for instance, a multi-party democracy. The indicators of this risk factor are thus mutually exclusive, implying that only one indicator can be rated in the case of *Pr-1* (Neuman, 2000).

In the case of *Pr14-Political (in)stability*, there is an indicator that measures unforeseen shifts in government policy (*positive, rate between 0-25; negative, rate between 26-50*). Although unforeseen shifts in government policy is not necessarily a good thing as such, the notion that such shifts can at least have positive results might warrant a rating closer to 25 than 50, but not closer to 0.

In the case of *Er12-Role of organized labour*, an interesting case comes to the fore. There is a risk factor indicator that measures compulsory membership of a labour organization (*no, rate between 0 and 20; yes, rate between 21 and 40*). Although membership of a labour organization might not be compulsory, one would think the rating should be closer to 0. Membership is often influenced by the advantages attached to being a card-carrying member of a labour union or being intimidated into joining a labour union and paying membership fees. These are social coercive sanctions rather than compulsory rules that would warrant a rating of closer to 20 than 40, but not closer to 0.

In certain cases, it may not be possible for the user of the model to provide a value for a certain risk factor indicator. The data might not be available, or it might be of suspicious origin, aged or unreliable. The user of the model can make up for the “missing data”, bearing the very important point in mind that missing data can be a serious problem because the validity and reliability of the eventual results can be severely jeopardized. As a solution, the indicators for which information is missing can be eliminated; the average scores for indicators where data is present can be substituted; data based on non-quantitative information about the indicators can be inserted; or a totally random value can be inserted (Neuman, 2000). As stated next to some of the risk factors, only some (more than one) of the risk factor indicators might be relevant – in such cases, irrelevant indicators can be scored 0. As these risk factors are indicative of political risk levels, and high levels of political risk are less conducive to the profitability of investment, it follows that the lower the score, the lower the perceived level of investment risk might be. In other words, if a risk factor indicator that measures the intensity of terrorist activity (an indicator of *Pr9-Political terrorism*) is completely irrelevant when analyzing the perceived level of political risk in a certain country, the indicator is either not scored at all or scored 0, a low score is compounded out of a possible weight of 110, thus contributing to a low risk rating for that country.

The model and guide to scoring is presented below. Each risk factor indicator is provided with rating increments, and Chapter 4 can be re-consulted should the context of the risk factor indicators be unclear. Together with each mentioned indicator a means of measuring these indicators is offered, in other words, what “signs” to look out for that will indicate the presence or development of risk factors that might pose possible present and future political risk to an investor. This chapter explains how these indicators can be weighed, and the value next to each

indicator represents that specific indicator's contributing "weight" in calculating possible risk when using the model.

The weights that are attributed to each risk factor and its indicators are purely subjective and, in illustration of the model's built-in adaptability and flexibility, can be adjusted to suit a client-specific model. For instance, an investor can choose to have *Pr10 (Role of the military)* weigh 100 instead of 250, or might choose to add or omit some of the indicators that point toward the presence of military unrest which might also alter the weighted value of *Pr10*.

Pr1-Political system (50) Rate only one indicator

- Autocratic single party system (Rate between 0 and 50)
- Democratic multi-party system (Rate between 0 and 20)
- One-party dominant democratic system (Rate between 0 and 30)
- Regulated democratic multi-party system (Rate between 0 and 30)
- Dictatorship in a non-party system (Rate between 0 and 50)
- Socialist central or transitional planning system (Rate between 0 and 40)

Pr2-Separation of powers (150) Rate all the indicators

- Degree of autonomy and independence of legislative, executive and judicial powers (High degree, rate between 0 and 10; moderate degree, rate between 11 and 30; low degree, rate between 31 and 50)
- Degree to which legislature, executive and judiciary check and balance powers (High degree, rate between 0 and 10; moderate degree, rate between 11 and 30; low degree, rate between 31 and 50)
- Trend of development of an over-powerful executive (Negative trend, rate between 0 and 10; possibility, rate between 11 and 30; positive trend, rate between 31 and 50)

Pr3-Openness of political system (250) Rate all the indicators

- Competitiveness of political system (Very open and competitive, rate between 0 and 10; possibility for competition, rate between 11 and 30; closed political system, rate between 31 and 50)
- Competing elites and interest groups can determine public policy through bargaining and compromise (Yes, rate between 0 and 25; no, rate between 26 and 50)
- Public accessibility regarding inputs (Very accessible, rate between 0 and 10; conditional, rate between 11 and 30; no access, rate between 31 and 50)
- Responsiveness, and responsibility of government (High degree, rate between 0 and 10; moderate, rate between 11 and 30; low, rate between 31 and 50)
- Transparency of decision making process and policy environment (Very, rate between 0 and 10; hardly, rate between 11 and 30; not at all, rate between 31 and 50)

Pr4-Public accountability of government (150) Rate all the indicators

- Strength of public protector, auditor general, transparency level (*Very strong; rate between 0 and 10; conditional power, rate between 11 and 30; none, rate between 31 and 50*)
- Degree of functioning oversight mechanisms (*Highly functional, rate between 0 and 10; conditional, rate between 11 and 30; useless, rate between 31 and 50*)
- Separation of private and public spheres (*High degree of separation, rate between 0 and 10; conditional, rate between 11 and 30; low degree, rate between 31 and 50*)

Pr5-Economic planning issues (100) Rate all the indicators

- Success or failure in meeting economic targets and deadlines promised by the political leadership (*Extreme failure, rate 50; complete success, rate 0*)
- Instances of misleading economic planning and policies (*Infrequent, rate between 0 and 25; frequent, rate between 26 and 50*)

Pr6-Form of government (50) Rate only one indicator

- If previous government was toppled by a military coup (*Rate between 0 and 50*)
- If a state of emergency results in interim government (*Rate between 0 and 30*)
- If a political system is undergoing transformation toward a multi-party government, or if multi-party elections are pending (*Rate between 0 and 50*)
- Stable government (*Rate between 0 and 10*)

Pr7-Racial, ethnic, religious, nationality, language issues (150) Rate relevant indicators

- If collective groupings (liberation movements) hedge against the political system (*Rate between 41 and 50*)
- No legitimacy for government (*Rate between 31 and 40*)
- Sudden changes in political party allegiances and/or alliances (*Rate between 11 and 20*)
- Occurrences of racially or ethnically motivated violence in past six months (*Rate between 21 and 30*)
- If none of the above prevail (*Rate between 0 and 10*)

Pr8-Border disputes/external conflict and international relations (110) Rate relevant indicators

- If a dispute is initiated in order to divert attention away from domestic economic problems (*Rate between 0 and 50*)
- Border disputes (land/sea/lake/river) or economic exploitation in disputed areas (*Rate between 0 and 30*)
- Long standing claims to historic territory contribute to domestic or international disputes or conflict (*Rate between 0 and 20*)
- If none of the above prevail (*Rate between 0 and 10*)

Pr9-Political terrorism (110) (In past six months – rate relevant indicators)

- Intensity of terrorist activity in past six months (*If high, rate between 31 and 50; if moderate, rate between 21 and 30; if low, rate between 0 and 20*)
- Government expenditure on terrorist defense (*Very high, rate between 31 and 50; moderate, rate between 21 and 30; low, rate between 0 and 20*)
- If such activity does not prevail (*Rate between 0 and 10*)

Pr10-Role of the military (250) Rate relevant indicators

- Past history of military unrest or mutiny (*Rate between 0 and 50*)
- Threat of military take-over if severe economic deterioration prevails (*Rate between 0 and 40*)
- If the military command stages a coup due to immobility in military ranks or an absence of benefits or remuneration (*Rate between 0 and 30*)
- Acts of unwarranted military prestige (*Rate between 0 and 20*)
- Little offensive military capability or intention (*Rate between 0 and 10*)
- Level of military involvement in government (*High, rate between 26 and 50; low, rate between 0 and 25*)
- Mobilization of military in order to enforce executive will (*Rate between 0 (benign) and 50 (malign)*)

Pr11-Legitimacy issues (240) Rate relevant indicators

- If there is a lack of homogenous national identity (*Rate between 0 and 30*)
- If there is a lack of distribution of resources (*Rate between 0 and 50*)
- If there is a lack of public participation (*Rate between 0 and 50*)
- If there is a lack of policy enforcement (penetration) (*Rate between 0 and 40*)
- If uncontrolled and rapid urbanization overtakes government functions (*Very debilitating, rate between 31 and 50, less debilitating, rate between 0 and 29*)
- If the political system is open and competitive (*Rate between 0 and 20*)

Pr12-Government behaviour (300) Rate all the indicators

- Degree of accountability of government (*More accountable, rate between 0 and 25; less accountable, rate between 26 and 50*)
- Degree to which limited or constitutional governance is practiced (*Unconstitutional, rate between 30 and 50; constitutional, rate between 0 and 29*)
- Degree of transparency of policy environment (*More transparent, rate between 0 and 20; less transparent, rate between 21 and 50*)
- Degree of responsiveness (*More responsive, rate between 0 and 25; less responsive, rate between 26 and 50*)
- Degree to which responsible governance is practiced (*More responsible, rate between 0 and 25; less responsible, rate between 26 and 50*)

- Level of government intervention into private sphere (*High level of intervention, rate between 26 and 50; low level of intervention, rate between 0 and 25*)

Pr13-Consequences of social revolution (150) Rate relevant indicators

- If a regime is threatened due to societal will (*If result is expected to be positive, rate between 0 and 20; if inconsequential, rate between 0 and 30; if negative, rate between 31 and 50*)
- A social revolution will alter the prospects of domestic and foreign investors (*Advantageously, rate between 0 and 20; inconsequential, rate between 0 and 30; disadvantageously, rate between 31 and 50*)
- Post-revolutionary society is altered ideologically (*Positively, rate between 0 and 20; inconsequential, rate between 0 and 30; negatively, rate between 31 and 50*)

Pr14-Political (in)stability (250) Rate relevant indicators

- Implication of major political events, i.e. surrounding elections or scandals (*Positive, rate between 0 and 25; negative, rate between 26 and 50*)
- State of flux or political (dis)equilibrium (*Stable, rate between 0 and 25; unstable, rate between 26 and 50*)
- Unforeseen shifts in government policy (*No, rate between 0 and 25; negative, rate between 26 and 50*)
- Unforeseen shifts in government's execution of power (*Positive, rate between 0 and 25; yes, rate between 26 and 50*)
- Governmental constraints on profit-taking (*None, rate between 0 and 25; some, rate between 26 and 50*)

Pr15-Civil War (200) Rate relevant indicators

- If domestic conflict within the boundaries of a country involves combatant civilians (*Rate between 0 and 50*)
- If civilians of different ethnic or religious origins are at war (*Rate between 0 and 50*)
- If civilians are at war for historic territory or autonomy (*Rate between 0 and 50*)
- Incidence of internal civil strife (*Low incidence, rate between 0 and 25; high incidence, rate between 26 and 50*)

Pr16-State of emergency (220) In last 18 months – rate relevant indicators

- If a state of emergency is expected or has been announced (*Rate between 0 and 30*)
- If a country has a history of emergency situations (*No, rate between 0 and 25; yes, rate between 26 and 50*)
- If declaring a state of emergency implies a political clampdown (*Rate between 0 and 40*)

- If a state of emergency is declared as a last resort to end long-standing instability (*Rate between 41 and 50*)
- If a state of emergency is the result of a “failed state” (*Rate between 0 and 50*)

Pr17-Economic expectations vs. reality (80) Rate both indicators

- Government success rate in fulfilling promises (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Incidence of unrest due to unfulfilled economic expectations (*Low, rate between 0 and 20; high, rate between 21 and 40*)

Pr18-Leadership succession issues (270) Rate relevant indicators

- A country has a history of authoritarian political structure (*Rate between 0 and 40*)
- A leadership vacuum is anticipated (*Rate between 0 and 40*)
- If a national social identity crisis occurs as a result of leadership succession (*Rate between 10 and 30*)
- If political civil unrest is a result of leadership succession (*Rate between 0 and 40*)
- Public scandals forces leadership succession (*Positive change, rate between 0 and 20; negative implications, rate between 21 and 40*)
- Expected re-election or smooth transition (*Rate between 0 and 40*)
- Successor to executive familiar and gradually introduced (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Pr19-Military in politics (120) Rate relevant indicators

- Government is under military control/influence (*Rate between 0 and 40*)
- If political leadership habitually wear uniform in public (*Rate between 0 and 40*)
- Definition, setting of and adherence to military boundaries/limitations (*Well-defined and maintained, rate between 0 and 20; ill-defined and ill-maintained, rate between 21 and 40*)

Pr20-Erosion of domestic support for the regime (80) Rate all indicators

- Level of economic and social deterioration (*Low levels, rate between 0 and 20; high levels, rate between 21 and 40*)
- An erosion of popular trust and confidence in government (*High levels of confidence, rate between 0 and 20; low levels of confidence, rate between 21 and 40*)

Pr21-Unconstitutional change of government (40) In past five years – rate one indicator

- One violent change of government has occurred (*Rate between 0 and 30*)
- More than one violent change of government has occurred (*Rate between 0 and 40*)

- If peaceful, yet unconstitutional change of government has occurred (*Rate between 0 and 20*)
- No unconstitutional changes have taken place (*Rate between 0 and 10*)

Pr22-Ideology as a political factor (80) Rate both indicators

- Degree of influence of secular ideology on government policies (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- Anti-systemic government policies prevail (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Pr23-Organised religion in politics (80) Rate both indicators

- Degree to which religion is a factor in government policy (*High, rate between 21 and 40; low, rate between 0 and 20*)
- Anti-systemic government policies prevail (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Pr24-Demographics, tradition and parochialism (360) Rate relevant indicators

- Do social problems pose a challenge to the viability of government (*No, rate between 0 and 20; inconsequential, rate between 0 and 30; yes, rate between 31 and 40*)
- If parochial values and structural elements in government contrast negatively with modern ideas and institutions in society (*Rate between 0 and 30*)
- Level of conflict of central government with modern elements of society (*Rate between 0 and 40*)
- Level of conflict of central government with traditional elements of society (*Rate between 0 and 40*)
- If clashes between tradition and modernity in society lead to incidents of violence (*Low incidence, rate between 0 and 20; high incidence, rate between 21 and 40*)
- Is urbanization controlled (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Does urbanization place a burden on the state system to provide social needs (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Can institutional and physical infrastructure handle rapid urbanization (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- A destabilizing dense urban population (*Rate between 0 and 40*)
- If demographics and traditional parochialism either do not occur, or are not destabilizing (*Rate between 0 and 10*)

Pr25-Corruption/nepotism in government and rent-seeking (100) Rate all indicators

- If corruption exceeds the bounds of domestic and/or international acceptance (*Rate between 0 and 40*)
- Companies have to budget for, or offer bribes (*Rate between 0 and 40*)

- Ranking on corruption perception indices (*Low, rate between 0 and 9; high, rate between 10 and 20*)

Pr26-Law tradition (110) Rate relevant indicators

- A tradition of order and the rule of law prevails (*Rate between 0 and 20*)
- A culture of lawlessness exists (*Rate between 0 and 40*)
- Level and quality of protection of investments under the sovereign law of a host country (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Government enforces and upholds order and stability (*Rate between 0 and 10*)

Pr27-Status of the media (130) Rate all indicators

- Public access to international media broadcasts are controlled (*No, rate between 0 and 15, yes, rate between 16 and 30*)
- Persecution of journalists for criticizing government prevails (*No, rate between 0 and 15; yes, rate between 16 and 30*)
- Level of institutionalized media censorship (*Low, rate between 0 and 15; high, rate between 16 and 30*)
- Level of voluntary self-censorship by media (*Low, rate between 0 and 15; high, rate between 16 and 30*)
- Media freedom uninhibited (*Rate between 0 and 10*)

Pr28-Human rights record (65) Rate relevant indicators

- Signatory and enforcement of human rights conventions and accords (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Basic human rights are denied due to racial, ethnic, political or traditional affiliations (*Rate between 0 and 30*)
- Basic human rights are upheld or enshrined in a constitution or Basic Law (*Rate between 0 and 5*)

Pr29-Quality of the bureaucracy (120) Rate all indicators

- Are government functions efficient and timely (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Is internal communication functional (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Does government misappropriate funds to the peril of public services (*No, rate between 0 and 15; yes, rate between 16 and 30*)
- Are competencies and abilities/professionalism of civil servants questionable and/or of low levels (*No, rate between 0 and 15; yes, rate between 16 and 30*)

Pr30-(Lack of) Political Will (65) Rate relevant indicators

- Extent to which public officials are career civil servants (*More, rate between 0 and 5; lesser, rate between 6 and 10*)
- Extent to which public officials are not in office for self-enrichment (*More, rate between 0 and 5; lesser, rate between 6 and 10*)

- Policy is designed and enforced in the best interest of the public (*Rate between 0 and 15*)
- Degree of political will (*High, rate between 0 and 15; low, rate between 16 and 30*)

Pr31-Involvement in international organizations (30)

- Member state of among others the United Nations, World Trade Organization, World Tourism Organization, International Telecommunications Satellite Organization, European Union, Organization of Petroleum Exporting Countries, SADC, African Union, SACU, ASEAN, NAFTA, NEPAD, etc. (*Active member, rate between 0 and 15; non-active member, rate between 16 and 30*)

Pr32-Domestic openness (120) Rate all the indicators

- Perception of domestic transparency (*High, rate between 0 and 10; low, rate between 11 and 20*)
- Modern legal frameworks (*If followed as such, rate between 0 and 10; if not, rate between 11 and 20*)
- Adherence to International Law (*If adhered to, rate between 0 and 10; if not, rate between 11 and 20*)
- Steps to eliminate the perception of corruption (*If such steps in place and effective, rate between 0 and 10; if such steps in place but ineffective, rate between 11 and 20; if no attempt to eliminate or curb corruption, rate between 21 and 30*)
- Building of strong modern institutions founded in stable political institutions (*If in place, rate between 0 and 10; if signs of development, rate between 11 and 20; if lacking, rate between 21 and 30*)

Pr33-Geographic position and geopolitics (130) Rate all the indicators

- Geopolitics (*If host country is in a favourable geopolitical position, rate between 0 and 10; if host country is in a vulnerable but manageable geopolitical position, rate between 11 and 20; if host country is in vulnerable and unmanageable geopolitical position, rate between 21 and 30*)
- Systemic status-rank (*If sustainably high, rate between 0 and 10; if climbing, rate between 11 and 20; if dropping, rate between 21 and 30; if very low, rate between 31 and 40*)
- Position in systemic conflict (*If not involved in such conflict, rate between 0 and 10; if a mediating force in systemic conflict, rate between 11 and 20; if direct party to such conflict, rate between 21 and 30*)
- Regional vulnerability (*Low degree of regional vulnerability, rate between 0 and 15; high degree of rate between 16 and 30*)

Pr34-Contract repudiation by government (210) Rate all indicators

- Cancellation of operating licenses (*No such instances, rate between 0 and 10; infrequent and selective instances, rate between 11 and 20; frequent and unexpected instances of cancellations, rate between 21 and 30*)
- Cancellation of import and/or export licenses (*No such instances, rate between 0 and 10; infrequent and selective instances, rate between 11 and 20; frequent and unexpected instances, rate between 21 and 30*)
- Cancellation of concession agreements (*No instances, rate between 0 and 10; infrequent and selective instances, rate between 11 and 20; frequent and unexpected instances, rate between 21 and 30*)
- Restrictions on remittances (*No restrictions, rate between 0 and 10; varying degrees, rate between 11 and 20; high degree, rate between 21 and 30*)
- Retraction of business licenses (*No past retractions, rate between 0 and 10; event-related past retractions, rate between 11 and 20; frequent and unmotivated retractions, rate between 21 and 30*)
- Government adherence to a lawful purchasing agreement (*Lawful compliance, rate between 0 and 15; failure to comply, rate between 16 and 30*)
- Creeping expropriation (*Few instances, rate between 0 and 15; many instances, rate between 16 and 30*)

Pr35-Selective Discrimination (210) In past 18 months – rate all indicators

- Ability to import the necessary equipment (*Investor able to import, rate between 0 and 10; imports negotiable, rate between 11 and 20; inability to import necessary equipment due to government restrictions rate between 21 and 30*)
- Ability to export (extracted minerals) (*Investor able to export, rate between 0 and 10; exporting negotiable, rate between 11 and 20; inability to export necessary equipment due to government restrictions rate between 21 and 30*)
- Degree of financial deficiency (*Government restrictions do not lead to financial deficiency of investment, rate between 0 and 15; restrictions lead to high levels of deficiency, rate between 16 and 30*)
- Forced abandonment (*No forced abandonment of investments in the past, rate between 0 and 10; trend of forced abandonment subsided, rate between 11 and 20; forced abandonment eminent or current, rate between 21 and 30*)
- Forced divestiture (*No forced divestiture of investments in the past, rate between 0 and 10; trend subsided, rate between 11 and 20; eminent or current, rate between 21 and 30*)
- Deprivation of mobile assets in past eighteen months (*None in the past, rate between 0 and 10; trend subsided, rate between 11 and 20; forced divestiture eminent or current, rate between 21 and 30*)
- Intellectual property rights disputes (*None in the past, rate between 0 and 10; possibility of flare-up, rate between 11 and 20; disputes lead to divestiture, rate between 21 and 30*)

Pr36-Political violence (240) In past 18 months – rate all indicators

- Revolutionary uprising (*None in the past, rate between 0 and 10; active and mobile revolutionary press or civil society keeps government in check, rate between 11 and 20; past trend of uprising as frequent reactionary force, rate between 21 and 30*)
- Rebellion (*None in the past, rate between 0 and 10; rebellion can lead to change in government, rate between 11 and 20; past trend of rebellion, rate between 21 and 30*)
- Insurrection (*None in the past, rate between 0 and 10; can lead to change in government, rate between 11 and 20; past trend of insurrection, rate between 21 and 30*)
- Hostile acts (*None in the past, rate between 0 and 10; can lead to policy changes, rate between 11 and 20; high frequency of hostile acts, rate between 21 and 30*)
- Enforcement of belligerent power (*State does not practice coercive governance, rate between 0 and 10; government threatens with but does not revert to state-violence, rate between 11 and 20; state-violence used against citizenry is political in nature, rate between 21 and 30*)
- Instances of terrorism (*None in the past, rate between 0 and 10; led to policy changes in government, rate between 11 and 20; high frequency of terrorist acts without responsibility taken, rate between 21 and 30*)
- Instances of mobilism and riots (*Civil commotion is organized, expected and within acceptable levels, rate between 0 and 10; commotion is volatile and instant, rate between 11 and 20; erupts into violence, rate between 21 and 30*)
- Instances of malicious damage and looting (*None, rate between 0 and 10; few instances, rate between 11 and 20, many focused on the presence of foreign businesses or MNCs, rate between 21 and 30*)

Pr37-Elections (260) Rate all indicators

- High voter turnout (*If high due to civil duty and participation, rate between 0 and 10; if due to intimidation, rate between 11 and 20*)
- Low voter turnout (*If low due to complacency, rate between 0 and 15; if due to lack of organization or due to rigging, rate between 16 and 30*)
- Election laws (*Internationally comparable and constitutional, rate between 0 and 10; election laws questionable, rate between 11 and 20; not adhered to or do not exist, rate between 21 and 30*)
- Internationally compliant (*Elections compliant with international standards, rate between 0 and 15; not compliant, rate between 16 and 30*)
- Open for scrutiny (*Monitors and observers allowed into the host country if necessary, rate between 0 and 15; sanctioned or not allowed at all, rate between 16 and 30*)
- Intimidation and violence (*No reports, rate between 0 and 15; frequent reports, rate between 16 and 30*)

- Irregularities (tampering, vote counting) (*No suspected irregularities, rate between 0 and 10; suspected, rate between 11 and 20; proven, rate between 21 and 30*)
- Media (*Total media freedom in election coverage, rate between 0 and 10; sanctioned, rate between 11 and 20; press intimidated, harassed and prevented from covering election, rate between 21 and 30*)
- International acceptance of result (*If accepted, rate between 0 and 10; if accepted with reservations, rate between 11 and 20; if unaccepted, rate between 21 and 30*)

Political Risk Factors: Economic

Er1-Degree of liberalization (120) Rate all risk factors

- Liberal investment, ownership and sectoral codes; incentives, floating foreign exchange rate (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Are imports kept in line with exports, is trade regime liberal (*Positive, rate between 0 and 20; negative, rate between 21 and 40*)
- Central bank only intervenes to stabilize foreign exchange rates (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Er2-Confiscation/expropriation (80) In past five – rate both indicators

- Country has a past record of confiscating foreign-owned enterprises (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Ideas of nationalism flare up periodically and pose a threat to foreign-owned enterprises (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Er3-Quality and nature of labour force (280) Rate all indicators

- There is a shortage of skilled labour (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Policies concerning the employment of expatriate (foreign) personnel are acceptable (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Labour is an organized and influential political force (*Less influential, rate between 0 and 20; highly influential, rate between 21 and 40*)
- Degree of corporatism (*High degree, rate between 21 and 40; low degree, rate between 0 and 20*)
- Impact of split in government, labour and/or civil society alliance (*High and consequential, rate between 21 and 40; low and inconsequential, rate between 0 and 20*)
- Degree of militancy and mobility of organized labour (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- Degree to which labour legislation is liberal (*High, rate between 0 and 20; low, rate between 21 and 40*)

Er4-Domestic economic strength (120) Rate all indicators

- Size of average disposable income (*Large, rate between 0 and 10; average, rate between 11 and 20; small, rate between 21 and 40*)
- Inflation rate hikes correspond to wage increases (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Trends in consumerism (*Decline, rate between 21 and 40; rise, rate between 0 and 20*)

Er5-Repatriation of profits (160) Rate all indicators

- Process of transferring profits out of the host country (*Easy, rate between 0 and 20; difficult, rate between 21 and 40*)
- Degree of convertibility of local currency (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Repatriation of profits guaranteed in investment code(s)/incentives (*Not secure nor guaranteed, rate between 21 and 40; conditional, rate between 20 and 30; guaranteed and possible, rate between 0 and 20*)
- Are alternatives to restrictions on repatriation viable or not (*Viable, rate between 0 and 20; not viable, rate between 21 and 40*)

Er6-Foreign ownership stake (160) Rate all the indicators

- Can investors' stake in an enterprise be larger than 50% (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Is less control acceptable in the hope of getting quick approval from the authorities (*Not necessary, rate between 0 and 20; yes, rate between 21 and 40*)
- Can local partners delay approval of business plans of foreign partners (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Allowance of and guarantee under international arbitration agreements (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Er7-Privatisation (160) Rate all indicators

- Host country favours monopolies and state enterprises/parastatals over private enterprises (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- "Large" private sector is protected by tariff barriers, monopolies or government contracts (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Private sector rather serves as routing channel for uncontrolled foreign exchange outflows (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Previously nationally owned enterprises have been privatized to improve service (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Er8-GDP (200) Rate all indicators

- A declining GDP would result in subsequent social intolerance of government (*No, rate between 0 and 20; yes, rate between 21 and 40*)

- Relative value of goods and services is acceptable (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Expenditure to produce goods and services is at an acceptable level (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Income received from producing goods and services is at an acceptable level (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Level of general and secondary economic activity (*High, rate between 0 and 20; moderate, rate between 10 and 30; low, rate between 21 and 40*)

Er9-Nationalisation of key industries/sectors (200) Rate all indicators

- Tendency toward nationalization (*Low and infrequent, rate between 0 and 20; high and frequent, rate between 21 and 40*)
- State-owned enterprises are monopolistic, protected from competition, and inefficient (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- State-owned enterprises are politicized, run and staffed by government supporters or retired military personnel (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- State-owned enterprises are export-oriented and competitive (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Are state-owned enterprises geared for positive expansion and development (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Er10-Losses from exchange controls (130) Rate relevant indicators

- If currency conversion crises prevail (*Rate between 0 and 40*)
- Central Bank manages to stabilize domestic currency against international exchange rates (*Rate between 0 and 20*)
- Fixed exchange rate prevails under high inflation (*Rate between 0 and 30*)
- Currency depreciation (*Anticipated and controlled, rate between 0 and 20; uncontrollable and rapid, rate between 21 and 40*)

Er11-Degree of protectionism (240) Rate all indicators

- Private enterprise is overly protected by tariffs (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Monopolies are protected from competition (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Non-tariff barriers hedge against competition (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Government contracts are the primary income of an industry (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Import substitution is subsidized (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Quotas, licensing or bureaucratic delays hedge against foreign investment (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Er12-Role of organized labour (160) Rate all indicators

- Implications of organization and mobility of labour (*No consequence, rate between 0 and 10; some consequence, rate between 11 and 20; serious consequence, rate between 21 and 30; extremely serious consequences, rate between 31 and 40*)
- Membership of a labour organization is compulsory (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Willingness of labour to negotiate rationally with management (*Willing, rate between 0 and 20; unwilling, rate between 21 and 40*)
- Confrontation between rival labour organizations is reason for incidents of violence (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Er13-Competitiveness (240) Rate all indicators

- Degree of export-led orientation followed in the economy (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Import substitution resulted in subsequent exports (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Is there a large number of domestic buyers and sellers of products produced locally (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Degree of interventionist measures practiced domestically by government (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- Degree of mobility of domestic factors of production (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Buyers and sellers are free to enter and leave the domestic market (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Er14-Level of government intervention (320) Rate all indicators

- Government economic planning is centralized (*Marginally, rate between 0 and 20; largely, rate between 21 and 40*)
- There is strict government control of import licenses (*Less restrictive, rate between 0 and 20; more restrictive, rate between 21 and 40*)
- Level of government control of new investment in terms of general or production targets (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- Banks are state-owned (*Some, rate between 0 and 15; mostly, rate between 16 and 30; all, rate between 31 and 40*)
- State-owned banks are selective in directing credit to certain sectors (*Not selective, rate between 0 and 10; moderately selective, rate between 11 and 25; very selective, rate between 26 and 40*)
- Industry and agricultural sectors are state-owned/controlled (*Some, rate between 0 and 10; mostly, rate between 11 and 25; all, rate between 26 and 40*)
- Entrepreneurship is promoted (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

- To what extent are inflexibility and inefficiency results of central planning (*Some, rate between 0 and 20; large, rate between 21 and 40*)

Er15-Economic impact of HIV/AIDS (200) Rate all indicators

- HIV/AIDS is a destabilizing factor in the host country economy (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Host government policy toward HIV/AIDS is realistic (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Will the infrastructure in the host country be able to cope with the consequences of HIV/AIDS (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- HIV/AIDS is a threat to the economic security of the host country (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- HIV/AIDS is a threat to regional economic security and stability (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Er16-Efficient banking system (180) Rate all indicators

- The existence of state-owned banks is complementary to privately owned banks (*To large extent, rate between 0 and 15; to some extent, rate between 16 and 30*)
- Interest rates are realistically determined (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Central Bank competency is recognized (*Internationally, rate between 0 and 15; regionally, rate between 16 and 30*)
- Personal funds are available on request (*Immediately, rate between 0 and 15; on application, rate between 16 and 30*)
- Foreign exchange is available on request (*Immediately, rate between 0 and 15; on application, rate between 16 and 30*)
- Private banking facilities are sophisticated, internationally competitive and comparable, and safe (*Yes, rate between 0 and 15; no, rate between 16 and 30*)

Er17-Confidence in finance ministry (60) Rate both indicators

- Competency of finance minister recognized (*Internationally, rate between 0 and 15; regionally, rate between 16 and 30*)
- Confidence in policy penetration (*High, rate between 0 and 10; medium, rate between 11 and 20; low, rate between 21 and 30*)

Er18-Real interest rate (90) Rate all indicators

- Interest rate minus inflation rate is low or high (*High, rate between 0 and 15; low, rate between 16 and 30*)
- Levels of the cost of borrowing money (*Low, rate between 0 and 15; high, rate between 16 and 30*)
- Real interest rate is coupled with a low inflation rate (*Yes, rate between 0 and 15; no, rate between 16 and 30*)

Er19-MIGA signatory and foreign direct investment (30)

- Host country is a signatory to the Multilateral Investment Guarantee Agency (*Full, rate between 0 and 15; conditional, rate between 16 and 30*)

Er20-Sound physical infrastructure (240) Rate all the indicators

- Goods can be transferred and delivered on time by air, road and rail (*To large extent, rate between 0 and 15; to a lesser extent, rate between 16 and 30*)
- Are there often electricity supply problems (*Not often, rate between 0 and 15; often, rate between 16 and 30*)
- Condition of public roads (*Good, rate between 0 and 10; fair, rate between 11 and 20; poor, rate between 21 and 30*)
- Availability of storage and warehousing capacity and facilities (*Readily, rate between 0 and 10; adequate, rate between 11 and 20; scarce, rate between 21 and 30*)
- Volumes of new property developments or industrial construction sites are in relation with general economic developments (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Regular flights in and out of the host country are reliable (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Repairs to damaged property or infrastructure are regularly undertaken (*Regularly, rate between 0 and 15; not so regularly, rate between 16 and 30*)
- Roads are maintained and networks improved (*Improved, rate between 0 and 10; maintained, rate between 11 and 20; neglected, rate between 21 and 30*)

Er21-Economic growth rate (150) Rate all indicators

- Trend toward a declining annual growth rate (*Slow decline, rate between 0 and 15; rapid decline, rate between 16 and 30*)
- Trend toward an increasing annual growth rate (*Fast increase, rate between 0 and 15; slow increase, rate between 16 and 30*)
- Economic growth creates employment (*High level, rate between 0 and 10; jobless growth, rate between 11 and 20; low level, rate between 21 and 30*)
- Measures taken to reverse temporary decline in economic growth (*In time, rate between 0 and 10; just in time, rate between 11 and 20; too late, rate between 21 and 30*)
- Extent to which economic growth in irreparable decline (*Some extent, rate between 0 and 15; large extent, rate between 16 and 30*)

Er22-Annual average inflation rate (120) Rate all indicators

- Escalation rate of inflation is rapid or slow (*Slow, rate between 0 and 15; rapid, rate between 16 and 30*)
- Investor can safeguard against a rising inflation rate by means of contract, or in the manner in which the organization structures itself in the host country

(To large extent, rate between 0 and 15; to some extent, rate between 16 and 30)

- Sudden rises of the inflation rate are a reflection of present distortions *(Trend will moderate, rate between 0 and 15; trend will intensify, rate between 16 and 30)*
- Rapidly rising prices signify a continuation of social and political problems associated with allocative inefficiency *(To some extent, rate between 0 and 15; to large extent, rate between 16 and 30)*

Er23-Economically active population (90) Rate all indicators

- Percentage of people between the ages of 16 and 65 years exceeding that of people between the ages of 0-15 years, and 66 years and above *(If trend is positive, rate between 0 and 15; if trend is negative, rate between 16 and 30)*
- Economically active population with easy access to health facilities and education *(Large measure, rate between 0 and 15; small measure, rate between 16 and 30)*
- Percentage of the economically active population having completed a secondary education *(High, rate between 0 and 15; low percentage, rate between 16 and 30)*

Er24-Change in real wages (90) Rate all indicators

- Real wages rise advantageously in relation to a rising inflation rate *(Yes, rate 0 and 15; no, rate between 16 and 30)*
- Changes in real wages result in labour protest *(Seldom, rate between 0 and 15; often, rate between 16 and 30)*
- Changes in real wages have disadvantageous social ramifications *(Seldom, rate between 0 and 15; often, rate between 16 and 30)*

Er25-Price index (150) Rate all indicators

- Rapid increases in the price index are prevalent *(No, rate between 0 and 15; yes, rate between 16 and 30)*
- Indexation reduces the immediate effects of price increases *(Constantly, rate between 0 and 15; sporadically, rate between 16 and 30)*
- To which degree are causative factors of inflation constant *(Lesser degree, rate between 0 and 15; large degree, rate between 16 and 30)*
- Is government winning or losing the battle against inflation *(Winning, rate between 0 and 15; losing, rate between 16 and 30)*
- To what extent is government neglecting economic matters in favour of political aims *(Lesser extent, rate between 0 and 15; large extent, rate between 16 and 30)*

Er26-Balance of payments (BOP) (120) Rate all indicators

- Is size of country's public sector in decline or on the increase *(Decline, rate between 0 and 15; increase, rate between 16 and 30)*

- Government uses some form of price intervention or special subsidies (*Few, rate between 0 and 15; many, rate between 16 and 30*)
- BOP expresses a moderate to very high government budget deficit (*Moderate, rate between 0 and 10; high, rate between 11 and 20; very high, rate between 21 and 30*)
- BOP expresses persistently high negative or positive values (*High positive, rate between 0 and 10; moderate, rate between 11 and 20; high negative, rate between 21 and 30*)

Er27-Discrimination against foreign business (160) Rate all indicators

- Non-tariff barriers prevent or improve the profitability of foreign investment (*Improve, rate between 0 and 15; prevent, rate between 16 and 30*)
- Licenses for foreign investors are subject to discrimination in allocation of export and other licenses (*To lesser extent, rate between 0 and 10; to large extent, rate between 11 and 20*)
- Inclusion of foreign investors in quotas (*Included, rate between 0 and 10; not included, rate between 11 and 20*)
- Bureaucratic delays purposefully keep foreign investors out of the market (*Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20*)
- Acquisition of a visa for entry/residence in a host country (*Difficult, rate between 11 and 20; easy, rate between 0 and 10*)
- Foreign investors are forced to adhere to prescribed hiring practices (*Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20*)
- Company taxes (*Moderate, rate between 0 and 10; high, rate between 11 and 20*)
- Product boycotts against foreign produce (*Seldom, rate between 0 and 10; often, rate between 11 and 20*)

Er28-Adequacy of international reserves (60) Rate all indicators

- Host country owns enough foreign reserves to cover three months worth of government expenses (*More than enough, rate between 0 and 10; less than sufficient, rate between 11 and 20*)
- Does a sizeable surplus or deficit prevail in the balance of payments (*Surplus, rate between 0 and 10; deficit, rate between 11 and 20*)
- Do imports exceed exports or does the opposite prevail (*Exports exceed, rate between 0 and 10; imports exceed, rate between 11 and 20*)

Er29-Debt service burden and foreign aid (120) Rate all indicators

- Host country reputation in servicing international debts (*Good, rate between 0 and 10; bad, rate between 11 and 20*)
- International creditworthiness is questionable or satisfactory (*Satisfactory, rate between 0 and 10; questionable, rate between 11 and 20*)
- Does debt service burden constitute more or less than 50% of GDP (*Less, rate between 0 and 10, more, rate between 11 and 20*)

- Debt service burden exceeds exports (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Debt service burden prevents social and economic development (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Debt service burden exceeds GDP (*No, rate between 0 and 10; yes, rate between 11 and 20*)

Er30-Preservation of resources (100) Rate all indicators

- Extinction of species is adequately controlled (*Adequately, rate between 0 and 10; inadequately, rate between 11 and 20*)
- Has government formulated and implemented adequate environmental plans (*Adequate, rate between 0 and 10; inadequate, rate between 11 and 20*)
- Population growth is a threat to the preservation of resources (*No threat, rate between 0 and 10; substantial threat, rate between 11 and 20*)
- Levels of water contamination (*Low, rate between 0 and 10; high, rate between 11 and 20*)
- Government practices development within national environmental legislation (*Yes, rate between 0 and 10; no, rate between 11 and 20*)

Er31-Deforestation rate (60) Rate all indicators

- Deforestation is adequately controlled (*Yes, rate between 0 and 10; no, rate between 11 and 20*)
- Deforestation is adequately coupled with reforestation programmes (*Yes, rate between 0 and 10; no, rate between 11 and 20*)
- Rate of reforestation is higher or lower than that of deforestation (*Higher, rate between 0 and 10; lower, rate between 11 and 20*)

Er32-Carbon dioxide emissions (60) Rate all indicators

- Government regulations result in a decline or increase of carbon dioxide emissions (*Decline, rate between 0 and 10; increase, rate between 11 and 20*)
- Successful government plans to regulate such emissions exist (*Yes, rate between 0 and 10; no, rate between 11 and 20*)
- Such emissions lead to incidence of acid rain (*Low incidence, rate between 0 and 10; high incidence, rate between 11 and 20*)

Er33-Trade issues and terms of trade (120) Rate all indicators

- Are terms of trade favourable or unfavourable (*Favourable, rate between 0 and 10; unfavourable, rate between 11 and 20*)
- Is rate of trade growth high or low (*High, rate between 0 and 10; low, rate between 11 and 20*)
- International trade features as a large or moderate share of GDP (*Large, rate between 0 and 10; moderate, rate between 11 and 20*)

- Levels of imports and exports are consistent with both a satisfactory economic growth rate and a financing gap which can be met (*Consistent, rate between 0 and 10; inconsistent, rate between 11 and 20*)
- Support of export promotion by government (*Large extent, rate between 0 and 10; lesser extent, rate between 11 and 20*)
- Competitive exchange rate maintained (*Yes, rate between 0 and 10; no, rate between 11 and 20*)

Er34-Unemployment rate (100) Rate all indicators

- Relation of unemployed percentage of the economically active population to the employed (*Does not exceed, rate between 0 and 10; exceeds, rate between 11 and 20*)
- High unemployment coupled with a low per capita income (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- High per capita income coupled with low unemployment (*Yes, rate between 0 and 10; no, rate between 11 and 20*)
- High employment rate is coupled with high inflation rate (*Yes, rate between 0 and 10; no, rate between 11 and 20*)
- High unemployment is coupled with low inflation (*Yes, rate between 0 and 10; no, rate between 11 and 20*)

Er35-Loan default/unfavourable loan restructuring (60) Rate all indicators

- Are structural adjustment programs (SAPs) being implemented at a high or moderate social cost (*Moderate, rate between 0 and 10; high, rate between 11 and 20*)
- Levels of interest accumulated on debt (*Acceptable, rate between 0 and 10; not acceptable, rate between 11 and 20*)
- Good or bad reputation of servicing international loans (*Good, rate between 0 and 10; bad, rate between 11 and 20*)

Er36-Government expenditure (100) Rate all indicators

- Level of public expenditure on defense (*Acceptable, rate between 0 and 10; high, rate between 11 and 20*)
- Level of government expenditure on defense supports the augmentation of military institutional power (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Level of public expenditure on health (*Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20*)
- Level of public expenditure on education (*Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20*)
- Government expenditure is organized along ethnic, language or social lines (*No, rate between 0 and 10; yes, rate between 11 and 20*)

Er37-Macroeconomic policy (120) Rate all indicators

- Sound macroeconomic policy (*Domestically and internationally, rate between 0 and 10; policy developing for improvement, rate between 11 and 20; policy goals not realistic, rate between 21 and 30*)
- Balance of payments record (*Budget surplus and high level of reserves, rate between 0 and 15; deficit and inadequate reserves, rate between 16 and 30*)
- Savings rates (*High, rate between 0 and 15; low, rate between 16 and 30*)
- Levels of capital investment (*High, rate between 0 and 15, low, rate between 16 and 30*)

Er38-Financial sector supervision (180) Rate all indicators

- Supervisory practices (*On par with international standards, rate between 0 and 15; questionable, rate between 16 and 30*)
- Foreign ownership limits and restrictions (*If easing, rate between 0 and 16; if tightened, rate between 16 and 30*)
- Capital (liquidity) requirements (*If increasing, rate between 0 and 15; if slackened, rate between 16 and 30*)
- Closing insolvent institutions (*If closed responsibly, rate between 0 and 15; if oversight results in insolvent institutions not being closed, rate between 16 and 30*)
- Sanctioning of financial practice (*Sanctioned and scrutinized, rate between 0 and 15; little transparency, rate between 16 and 30*)

Er39-Vulnerability spread (90) Rate all indicators

- Reliance on oil imports (*Flexible level of vulnerability to oil supply and prices, rate between 0 and 15; high level of reliance on oil imports and consequent vulnerability, rate between 16 and 30*)
- Export of single commodity (*Many commodities exportable, rate between 0 and 15; single commodity exported concomitant to high level of commodity market and climate vulnerability, rate between 16 and 30*)
- Reliance on single commodity (*Degree of market and climate sensitivity of single commodity low, rate between 0 and 10; if sensitive but manageable, rate between 11 and 20; if highly sensitive, rate between 21 and 30*)

Er40- Stability and ability of central banks (160) Rate all indicators

- Extent of central bank insurance (*Adequately insured, rate between 0 and 15; inadequate, rate between 16 and 30*)
- Qualifications, profile and competence of central bank management (*Proven competent, rate between 0 and 15; low levels of competence, rate between 16 and 30*)
- Level of central bank independence and levels of state intervention (*High level of independence and low level of interference, rate between 0 and 15; low level of independence and high level of interference, rate between 16 and 30*)

- Size of foreign reserve in months-worth coverage (*In excess of three months, rate between 0 and 10; less than three months, rate between 11 and 20; insignificant level of foreign reserves, rate between 21 and 30*)
- Are banking and financial supervisory laws upheld (*At all times and in all instances, rate between 0 and 10; occasionally, rate between 11 and 20; laws exist but are not upheld, rate between 21 and 30; laws do not exist at all, rate between 31 and 40*)

Er41-Fiscal prudence (220) Rate all indicators

- Loan classification and bank licensing (*Tight rules upheld, rate between 0 and 10; rules exist but are not upheld, rate between 11 and 20; rules do not exist at all, rate between 21 and 30*)
- Bankruptcy laws (*Meet international standards, rate between 0 and 10; laws exist but are not internationally comparable, rate between 11 and 20; no bankruptcy laws exist, rate between 21 and 30*)
- Guidelines for the assessment of owners, board members and managers of financial institutions (*Well established, internationally valid and enforced, rate between 0 and 10; guidelines exist but are not enforced, rate between 11 and 20; no existing guidelines, rate between 21 and 30*)
- Banking supervision laws and regulations (*Tight laws, prudent regulations are enforced, rate between 0 and 10; laws and regulations exist but are not enforced, rate between 11 and 20; no laws and regulations exist, rate between 21 and 30*)
- Strong rules governing disclosure, auditing and accounting practices (*Are enforced, rate between 0 and 10; exist but are not enforced, rate between 11 and 20; no such rules exist, rate between 21 and 30*)
- Deposit-insurance scheme in place (*In place and functional, rate between 0 and 10; exists but unlikely to function, rate between 11 and 20; no such schemes exist, rate between 21 and 30*)
- Privatization of institutions experiencing high levels of state intervention (*Strategies in place met with little resistance, rate between 0 and 10; strategies in place met with resistance, rate between 11 and 20; no such strategies are in place but talks have commenced, rate between 21 and 30; no such strategies exist, rate between 31 and 40*)

Political Risk Factors: Social

Sr1-Government investment in human capital (110) Rate both indicators

- Government investment in quality of labour (*High levels of investment with positive results, rate between 0 and 20; high levels of investment, but ineffective, rate between 21 and 40; little or no signs, rate between 41 and 60*)
- Financing of skills development (*Skills levies can be claimed back from government, rate between 0 and 25; another system of skills development is in place, rate between 0 and 25; if system is not in place, nor any other such system, rate between 25 and 50*)

Sr2-Literacy rate (30)

- Is the literacy rate of the economically active population higher or lower than 50% (*Higher, rate between 0 and 15; lower, rate between 16 and 30*)

Sr3-Job mobility impediments (60) Rate both indicators

- Public sector education lags behind education in business, engineering and science (*Immeasurably, rate between 0 and 10; measurably, rate between 11 and 20; seriously, rate between 21 and 30*)
- A pool of educated but discontented people developed, demanding appropriate employment (*Low measure of discontent, rate between 0 and 10; moderately discontent, rate between 11 and 20; large measure of discontent, rate between 21 and 30*)

Sr4-Gini coefficient (60) Rate one indicator

- Gini coefficient is between 0.30 (highly equal distribution of income) and 0.70 (highly unequal distribution of income) (*Rate between 11 and 20*)
- Gini coefficient is lower than 0.30 (*Rate between 0 and 10*)
- Gini coefficient is higher than 0.70 (*Rate between 21 and 30*)

Sr5-Education ratio - student:teacher (30)

- Is the ratio less or more than 26 pupils per teacher (*Less, rate between 0 and 15; more, rate between 16 and 30*)

Sr6-Per capita income (30)

- Is a positive or negative annual growth rate of per capita income prevailing (*Positive, rate between 0 and 10; stagnant, rate between 11 and 20; negative, rate between 21 and 30*)

Sr7-Mean period of schooling (60) Rate one indicator

- If mean period of schooling exceeds 10 years (*Rate between 0 and 10*)
- If mean period of schooling is 10 years (*Rate between 11 and 20*)
- If mean period of schooling is less than 10 years (*Rate between 21 and 30*)

Sr8-Unemployment rate (30) In last quarter

- Percentage rise in the unemployment rate (*Low, rate between 0 and 15; high, rate between 16 and 30*)

Sr9-Attitude toward foreign businesspeople/visitors (120) Rate all indicators

- Acquiring a visa is laborious, expensive and difficult (*No, rate between 0 and 15, yes, rate between 16 and 30*)
- Are travelers harassed at airports, i.e. by (military) personnel (*No, rate between 0 and 10; moderately, rate between 11 and 20; frequently, rate between 21 and 30*)

- Attacks on tourists and foreigners prevail (*Infrequently, rate between 0 and 10; frequently, rate between 11 and 20; excessively rate between 21 and 30*)
- Are tourist concessions implemented (*Equal to international norms, rate between 0 and 10; less than norm, rate between 11 and 20; not at all, rate between 21 and 30*)

Sr10-Acceptable quality of life (90) Rate all indicators

- Access to public services (*Easy, rate between 0 and 10; conditional, rate between 11 and 20; difficult, rate between 21 and 30*)
- Level of crime rate (*Low, rate between 0 and 10; moderate, rate between 11 and 20; high, rate between 21 and 30*)
- Is life expectancy in excess of an average of 66 years (*Yes, rate between 0 and 15; no, rate between 16 and 30*)

Sr11-Urbanisation rate (150) Rate relevant indicators

- Pressure of urbanization on government spending, i.e. infrastructure (sewerage, roads, electricity, housing and the maintenance of law and order) (*Moderate, rate between 0 and 10; increasing, rate between 11 and 20; exceptional, rate between 21 and 30*)
- Decline in agricultural productivity due to urbanization (*Moderate, rate between 0 and 10; increasing, rate between 11 and 20; extensive, rate between 21 and 30*)
- Does urbanization place a burden on the state system to provide social needs (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Can institutional and physical infrastructure handle rapid urbanization (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- A destabilizing dense urban population (*Rate between 0 and 30*)

Sr12-Population (40) Rate both indicators

- Percentage of population growth per annum exceeds the percentage of employment growth per annum (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Number of live births per annum exceeds the number of deaths per annum (*No, rate between 0 and 10; yes, rate between 11 and 20*)

Sr13-Average calorie intake and nutrition (20)

- If average calorie intake is less than 2100 per day (*Rate between 11 and 20*)
- If average calorie intake is more than 2100 per day (*Rate between 0 and 10*)

Sr14-Health care (150) Rate relevant indicators

- Ratio of population per doctor is less than 4000 (*Rate between 0 and 5*)
- Ratio of population per doctor is between 400 and 4800 (*Rate between 6 and 15*)
- Ratio of population per doctor exceeds 4800 (*Rate between 16 and 20*)

- Ratio of nurses per doctor exceeds 2 (*Rate between 0 and 10*)
- Accessibility of health care facilities and health care professionals (*Very accessible, rate between 0 and 25; not accessible, rate between 26 and 50*)
- Government health policy (*Realistic, rate between 0 and 25; unrealistic, rate between 26 and 50*)

Sr15-Life expectancy (20) Rate one indicator

- If life expectancy exceeds an average of 66 years (*Rate between 0 and 10*)
- If life expectancy is less than an average of 66 years (*Rate between 11 and 20*)

Sr16-Infant mortality rate (20) Rate one indicator

- If the infant mortality rate exceeds 48 per 1000 live births (*Rate between 11 and 20*)
- If the infant mortality rate is less than 48 per 1000 live births (*Rate between 0 and 10*)

Sr17-Telephone communication and ICT (20) Rate one indicator

- If the number of telephones exceeds 130 per 1000 people (*Rate between 0 and 10*)
- If the number of telephones is less than 130 per 1000 people (*Rate between 11 and 20*)

Sr18-Population access rates (40) Rate all indicators

- If facilities can be reached on foot or by the local means of transport within one hour by at least 50% of the population (*Rate between 6 and 10; if more than 50%, rate between 0 and 5*)
- If at least 79% of the population has access to health services (*Rate between 0 and 5; if less, rate between 6 and 10*)
- If at least 69% of the population has access to safe water (*Rate between 0 and 5; if less, rate between 6 and 10*)
- If at least 36% of the population has access to sanitation (*Rate between 0 and 5; if less, rate between 6 and 10*)

Sr19-Provision of public services (25) Rate all indicators

- Provision of public services is unreliable, sporadic and vulnerable to incompetence (*Rate between 0 and 10*)
- A culture of non-payment for public services prevails (*Rate between 0 and 10*)
- Public services are reliable (*Rate between 0 and 5*)

Sr20-Global Human Development Rating (HDI) (10) Rate one indicator

- If HDI rates a country in the "high" category – averaging 0.916 (*Rate between 0 and 2*)
- If HDI rates a country in the "medium" category – averaging between 0.570 and 0.759 (*Rate between 3 and 5*)

- If HDI rates a country in the “low” category – averaging 0.389 (*Rate between 6 and 10*)

Sr21-Daily newspapers (10)

- If there is an average of 96 copies per 1000 people (*Rate between 0 and 5; if less, rate between 6 and 10*)

Sr22-Radio and television (10)

- If there is an average of 350 radio receivers per 1000 people (*Rate between 0 and 5; if less, rate between 6 and 10*)

Sr23-Social consciousness and conscience of government (60) Rate both indicators

- Investment in social capital and entrepreneurship (*Actions in place for the investment in developing social capital and entrepreneurship are showing results, rate between 0 and 10; actions are under development but not yet implemented, rate between 11 and 20; no such actions in place, rate between 21 and 30*)
- Openness/competitiveness in technological skills (*Development of technological skills results in technological competitiveness and openness, rate between 0 and 10; development programme is in early stages, rate between 11 and 20; development of and investment in technological skills not a priority, rate between 21 and 30*)

Sr24-Societal uprising (120) In past 18 months – rate all indicators

- Violence, demonstration(s) aimed at MNCs (*None, rate between 0 and 10; trend is noticeable, rate between 11 and 20; flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances, rate between 31 and 40*)
- Instances of collective subversion, looting, vandalism (*None, rate between 0 and 10; trend is noticeable, rate between 11 and 20; flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances, rate between 31 and 40*)
- Malicious damage (*None, rate between 0 and 10; trend is noticeable, rate between 11 and 20; flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances, rate between 31 and 40*)

Sr25-Climate (40)

- Is country situated in tropical or subtropical climatic zone (*If no, rate between 0 and 20; if yes, rate between 21 and 40*)

Notes

- 1 This being an interval scale for measuring political risk, although an ordinal scale (with say, only two values per risk factor indicator) might be more appropriate in an even further refined model building exercise, with an even more advanced research base to work from.
- 2 The theory of probability is one of the most widely used branches of mathematics in practice in decision making – especially so in financial risk, i.e. the life insurance industry.
- 3 Private consultation with Albert Venter, 14 October 2002.
- 4 A limitation of this study is that it does not present a distribution curve of political risks. Although not the intention of this study, it is indeed a theme that can be regarded in the light of scope for further studies in the theory of political risk analysis.
- 5 This model is concerned with the relationship between the risk factor indicators, and, the fact that they are weighted, is to enable the quantitative analysis of political risk (Neuman, 2000, p. 17).

Chapter 6

Managing Political Risk

Introduction

Investors put assets at risk to achieve their objectives and the analysis of these risks, including political risks, is a key to successful operations. Weighing up opportunities against potential losses becomes possible after an initial political risk assessment. Of course, the nature of risks an investor might face depends upon the project; the factors present in a host country's investment climate that are associated with the project; cultural prevalence; and the individuals that make up the organization. Opportunities and risks are often a double-edged sword, and the management of political risks is but one of the challenges a Multinational Company (MNC) faces in a host country.

A firm's foreign investment strategy deals with the positioning of the organization in an uncertain host country environment and investment climate. As such, organizational strategic choices determine the size of a firm's exposure to uncertain environmental and organizational components that impact on company performance. This chapter will attempt to explain how a firm's political risk exposure (the sensitivity of a firm's projected profitability and operationability in a host country to changes in the investment climate) can be managed and reduced.

Formulating and designing a political risk policy as a means of managing political risk is a key point in this chapter. So far in this book, a lot of time has been spent on identifying, analyzing and measuring political risk. These are very important to any investor in finding the most viable investment opportunity and being aware of the political risks involved. Now that it has been shown that this can indeed be established, an investor can make decisions based on the ways in which the political risks in a chosen investment environment can be curbed or minimized, if not avoided.

This book has taken some existing ideas embedded in management science and adapted them to the needs of political risk management. It offers some ideas regarding the management of political risk once these risks have been identified in the light of the characteristics of MNCs; challenges for management; orientation toward host-countries; political forces; MNC-host country relations; MNC strategies; integrative and protective management techniques; managing the role-players in foreign direct investment; political risk insurance; political risk policy design; and political risk impact-probability management (see also Moran (ed.), 1998).

Conceptualizing Political Risk Management

The analysis of political risk, by means of applying the model offered in Chapter 5, now makes it possible for investors to take the assessment results and consider the further viability of the investment. This is done in light of the strategies that will have to be implemented in order to manage these risks and thus ensure that the profitability of the investment can be secure. Foreign (direct) investment, the establishment or expansion of operations in a foreign country by means of the transfer of capital, is not only a means of expanding a firm's competitive advantage. Producing in another country is also a remedy to some investment problems often experienced by firms considering foreign investment as a means of avoiding difficulties in exporting due to product tariffs imposed on imports. Manufacturing a product might require natural resources that are available only in certain areas of the world, and establishing access to these resources becomes imperative. Competition often drives domestic firms to improve efficiency and decrease the costs of production. Firms might venture into countries where the cost of producing these goods (or services) is relatively cheaper in terms of capital expenditure, energy, natural resources or labour. Unlike capital, many of these factors are still not mobile and firms necessarily have to seek these resources rather than attract them (Czinkota, Ronkainen, Moffett and Moynihan, 1998).

The fact that capital has become extremely mobile enables foreign investment despite the fact that some input resources may not be as mobile. But where large amounts of capital are at stake, the management of that capital and its final product(s) is of extreme importance.

Yet the true overall cost of risk in foreign direct investment rarely includes the costs of political risks. This is very disconcerting, as very restricted views of the costs of political risks are taken that may lead to grave misunderstandings about the real economic significance of political risk. This is often due to a lack of awareness of all the components of risk, and an absolute belief in the conventional costing of investment risk in particular industries or organizations (Kennedy, 1991).

Establishing operations in other countries not only gives a company access to new markets and specialized resources, it also opens up new sources of information and knowledge to stimulate further product development, and broadens the options of strategic moves and countermoves the company might make in competing with its domestic and international rivals. This competition often takes place in uncertain environments and politically risky investment climates. With new opportunities come the challenges of managing strategy, organization, and operations that are complex, diverse and uncertain due to the foreign investment climate that domestically experienced firms encounter in host countries. Political risk management is thus taken to be the sum of the actions foreign investors or MNCs take to try and keep at an acceptable level the degree or measure of investment risk associated with their activities. These activities include the implementation of the initial idea of expanding abroad; government reaction to these activities; specific policy actions that may impact negatively on the

profitability of a firm's idea of expanding abroad; or any number of factors measured in the book (Bartlett and Ghoshal, 2000; Chicken, 1996).

Among the trends in foreign direct investment has been the emergence of *service* MNCs and a shift away from traditional ownership patterns between the parent company and its worldwide operations in various host countries, to a new and varied set of financial, legal, and contractual relationships with different foreign affiliates. The notion of foreign investment is not restricted to only production facilities as such.

Among the earliest motivations that drove companies to invest abroad was the need to secure key supplies, market-seeking behaviour and access to low-cost factors of production. Of course, these attractive factors in foreign countries do not come without a host of significant problems. Early international expansion of MNCs often took place without clearly defined global objectives or well-developed international strategies, despite the motivations that made internationalization essential for a company to survive in a particular business. It became clear that being a *multinational* rather than a national company brought important advantages of competitive positioning (Bartlett and Ghoshal, 2000; Kennedy, 1991).

As explored in previous chapters, an MNC faces certain macroeconomic risks that are outside its control. These include events such as wars and natural disasters, as well as random movements in wage rates, interest rates, exchange rates and commodity prices.

The political risks that MNCs face arise from, among other things, the policy (in)actions and reactions of a host government. In light of the inseparable relationship between business, economics, and politics, the net effects of government policy are often indistinguishable from the effect of macroeconomic forces. Still, from a management perspective at least, the two are distinguishable in the sense that macroeconomic risks are uncontrollable, but political risks are, to some extent, partially controllable or can at least be managed by MNCs.

An MNC also faces certain competitive risks that arise from the uncertainties of host country competitors' responses to its strategies, as well as internal resource risks. Such risks come to the fore in cases where an MNC's strategy requires resources that the company does not have, cannot acquire, or cannot spare. A key resource risk for most firms is managerial talent, but resource risks can also arise from lack of appropriate technology, or even capital (Bartlett and Ghoshal, 2000; Kennedy, 1991).

It seems that the common characteristics of these types of risks are that they vary across countries and that they change over time. This makes flexibility the key strategic political risk management requirement for MNCs, since the diversity and volatility of host country investment environments create both opportunities and risks that should be considered jointly.

After considering the results of a risk assessment, investors presumably take some kind of action. They may choose to proceed with a project and ignore the risks, or consider them as risks that need to be taken. They may attempt to modify the arrangements or circumstances of their investment. For example, if one part of a country is experiencing civil strife, they may opt to operate in a part of the

country that is less dangerous, thus avoiding the risky area until the situation changes (Coplin and O'Leary, 1994; Howell (ed.), 1998).

But host country governments can argue that political risk analyses, a first-step in establishing a political risk management strategy for an MNC, are inaccurate because ethnic tension did not evolve into civil strife and subsequent war damage. However, this is by no means an indication that the particular risk was not present. It may have been avoided or managed – either by the investor or the host government – to such an extent that potential harm was avoided or eliminated (Coplin and O'Leary, 1994; Howell (ed.), 1998).

Some introductory examples of managing political risk include negotiating a better deal with the host country government. If there is a high level of government interference in employment policies prior to the investment, the investor can seek (and obtain) a variation in convertibility limits or in tax levels in exchange for accommodating the host government. This can only be done, however, if the investor knows the social environment of the employment issues and the implication this holds for business operations. As an example of active political risk management, investors can develop alliances within the host country and even within the government that can elevate their position and help avoid the risk circumstances. This may be risky in itself if the faction or government they have aligned themselves with falls into disfavour (Coplin and O'Leary, 1994; Howell (ed.), 1998).

The discussion will proceed with explaining the characteristics of MNCs, in that they not only experience political risk as such, but that they might even contribute to a host country's level of potential political risk by prompting government reaction to MNC behaviour. The following section will also introduce ways that MNCs can deal with political risks, and suggests ways of managing these risks.

Characteristics of the MNC: In the Line of Fire or the Firing Squad?

The most fundamental difference between an MNC and a national company is based on their social, political and economic contexts. Many national companies remain inside domestic borders and conduct importing and exporting of goods and services, other companies might relocate, and some have branches or operations in many different countries. MNCs face diverse and conflicting demands and pressures in different host countries, due to differing social and cultural norms, government regulations, customer tastes and preferences, and the social and economic structures of the businesses as such (Bartlett and Ghoshal, 2000).

For most issues, the state represents the ultimate rule-making authority against which little appeal is possible. Consequently, MNCs face an additional and unique element of risk, namely that of operating in countries with different attitudes toward political philosophies, legal systems, social attitudes toward private property, corporate responsibility and free enterprise. Furthermore, MNCs are required to measure and maintain financial results against fluctuating currencies

and shifts in exchange rates. This must be accomplished in an organization that is divided by barriers of distance and time, and impeded by differences in language and culture (Bartlett and Ghoshal, 2000).

MNCs are exposed, (in)directly and (un)willingly, to both the cooperative and conflicting events occurring within and among countries, as they are constantly confronted with the ripple effects resulting from uncontrollable forces at play beyond home country borders. Furthermore, MNCs attract a lot of attention especially in developing countries, as wielders of economic power when bargaining¹ with host country governments (Brummersted, 1988; Doz and Prahalad, 1980; Fagre and Wells, 1982; Lecraw, 1984; Poynter, 1982).

This attention is augmented by the increasing interdependence that accentuates the direct impact that non-governmental interests can have on the policy-making process(es) of governments, and there is an ever-increasing trend of direct interaction between corporate entities like MNCs and host governments.² The political role of MNCs has also been enhanced by pervasive economic and moral issues such as triple bottom lining; socially and environmentally responsible investment; trade distribution; the allocation of declining reserves of raw materials; continued access to global markets; protection of the physical environment; investment in human capital; and surveillance over emerging technologies (Brummersted, 1988; Mahini, 1988).

Apart from their capabilities MNCs have certain vulnerabilities as well. They can be manipulated by both home and host governments, and direct investment creates a trans-national interdependence that governments may exploit in order to exact some form of concession. Also, whether intended or not, MNC activity has given rise to conflicts of jurisdiction and problems of territoriality regarding antitrust, trade restrictions, capital controls and taxation policy. They have had major effects on the flow of trade and money since a significant portion of international trade takes the form of intra-enterprise transactions between MNCs (Brummersted, 1988; Kobrin, Bask, Blank and La Palombara, 1980; Kraar, 1980).

Still government remains the most important wielder of power in the international system and state sovereignty tends to dominate when determining the conditions under which firms are allowed to operate. MNCs face the problem of continually evaluating their relative situations regarding host countries and their international climates in an effort to minimize risks abroad (Brummersted, 1988; Vernon, 1971).

Challenges for MNC management

MNCs use global strategies to achieve the benefits of cost reductions, improved quality of products and programmes, enhanced customer preference and increased competitive leverage (Kennedy, 1991; Yip, 2000). Yet global strategy can incur significant management costs through a necessary increase in coordination, reporting requirements, and even additional core staff. This can actually reduce the effectiveness of the firm in individual host countries if over-centralization harms local motivation and morale (Yip, 2000).

Managing an MNC demands a perspective that can see opportunities and risks across national boundaries and functional specialties, and a skill to coordinate and integrate activities across these barriers to capture the potential benefits. This implies involvement in a variety of diverse activities, of which the balance will vary considerably depending on the nature of the business and the MNC's administrative tradition (Bartlett and Ghoshal, 2000).

MNC orientation toward host countries Ethnocentric attitudes of MNCs in host countries are revealed when the message "it should work just as well in a host country than in a home country" is communicated from headquarters to the subsidiary. On the other hand, polycentric firms are those that, by experience or by the inclination of an executive, begin with the assumption that host-country cultures are different. They assume that since people are different in each country, standards of performance, incentives and training methods must be different, and local environmental factors are given greater weight (Perlmutter, 2000).

The advantages of ethnocentric management are revealed in the short term as organization is simpler, and there is a higher rate of communication of knowledge and know-how from headquarters to new markets. There is also more control over appointments to senior posts in subsidiaries. Polycentrism's costs are wasted due to duplication, decisions to make products for local use but which could be universal, and also due to inefficient use of home-country experience. The risks in this case include an excessive regard for local traditions and local growth at the expense of global growth. On the other hand, the advantages of polycentrism are an intense exploitation of local markets; better sales since local management is often better informed; more local initiative for new products; more support from host country governments; and good local managers with high morale (Perlmutter, 2000).

An important strategic task facing managers of all MNCs is how to respond to the specific environments of the different countries in which their company operates. As explained before, host environments differ in terms of political systems, government regulation of domestic and foreign companies, social norms, and cultural values. These differences should prompt managers to rather be sensitive and responsive to national, social, economic and political differences in the host countries in which they operate (Perlmutter, 2000; Kennedy, 1991; Vernon, 1971).

MNCs and host governments – mutual benefits... While cultural differences among countries have been an important localizing force, diverse demands and expectations of home and host governments as well as hostile negotiations, have probably been the most severe constraint to the global strategies of many companies.

Yet MNCs and host governments can still bring mutual benefits to each other. To the host government, the MNC can represent an important source of funds, technology, and expertise that could help further national priorities such as regional development, employment, import substitution and export promotion. To the

MNC, the host government can represent the key to local-markets or access to resources that provide new opportunities for profit, growth, and improvement of its competitive position (Bartlett and Ghoshal, 2000; Doz and Prahalad, 1980; Kennedy, 1991; Poynter, 1982; Vernon, 1971).

...or mutual aggressors A disadvantageous relationship between host governments and MNCs often arise from differences in their motivations, objectives, and evaluation criteria. To be effective global competitors, MNCs try to improve their economic efficiency and attempt to gain strategic positions that give them leverage over other companies. MNCs often seek the important operating objectives of unrestricted access to resources and markets throughout the world; the freedom to integrate manufacturing and other operations across national boundaries; and the unimpeded right to coordinate and control all aspects of the company on a worldwide basis. MNCs concentrate on the disadvantages of various government restrictions on their operations.

Host governments, on the other hand, usually seek to develop an economy that could survive and prosper in a competitive international environment. This objective might lead to the designation of a "national champion" in a specific industry, bringing it into direct competition with an MNC. Although both parties might be partners in search of global competitiveness, the MNC usually hopes to achieve it within the international economic system, while the host government strives to capture it within its national boundaries (Bartlett and Ghoshal, 2000; Doz and Prahalad, 1980; Kennedy, 1991; Poynter, 1982; Vernon, 1971).

The potential for conflict between host governments and MNCs arise not only from economic, but also from social, political and cultural issues. Even without the maliciousness of some MNCs that blatantly try to manipulate host government structures or policies, they can still represent a political threat due to their size, power, and influence – particularly in vulnerable developing economies (Doz and Prahalad, 1980).

Potential for conflict is also inherent in the different measurement systems adopted by the two partners. Due to their objectives being fundamentally economic in nature, MNCs can assess their situation and measure their performance in essentially economic and competitive terms. Governments, on the other hand, usually define their goals in terms of social, political and economic outcomes, and measure performance against socio-economic and not only economic criteria. Given the potential differences between economic and social returns, these differences in measurement criteria lead to significant differences in their evaluation of alternative courses of action.

Due to these different objectives, motivations, and measures, MNC-host government relationships are often seen as a "zero-sum game" in which the outcome depends on the balance of power between the MNC and the host government, where governments control access to local markets for which MNCs compete, and MNCs in turn have financial, technological and managerial resources for which national governments compete. The rapidly growing power of global companies can be perceived as a threat, not only by other companies but by various

national governments that see their social and economic policies being disrupted by rising import penetration (Bartlett and Ghoshal, 2000; Doz and Prahalad, 1980; Kennedy, 1991; Poynter, 1982; Vernon, 1971).

Receptive multinational strategies Ideally, multinational industries are worldwide businesses in which the national differences in cultural, social and political environments make multiple national industry structures flourish. Success in this case is typically achieved by companies that follow multinational strategies of building strong and resourceful national subsidiaries that are sensitive to local market needs and opportunities, and strategically manage an eventual “fit” with a host country’s political and policy environment (Bartlett and Ghoshal, 2000; Fagre and Wells, 1982; Lecraw, 1984).

Yet each host country in which an MNC functions is usually chosen as the destination for foreign investment due to four broad attributes. These attributes, viewed as major contributors to a (host) country’s investment climate, are factor conditions; demand conditions; related supporting industries; and importantly, firm strategy, structure, and rivalry. Porter (1990) expands by explaining that factor conditions refer to a host country’s position in factors of production, such as skilled labour or infrastructure which are necessary in order to compete in a given industry. Demand conditions refer to the nature of the home market demand for the industry’s product or service. Related and supporting industries encompass the presence or absence in the host country of supplier industries and other related industries that are also internationally competitive. Finally, firm strategy, structure, and rivalry refer to the conditions in the host country that govern the way in which companies are created, organized, and managed, as well as the nature of domestic rivalry. These four factors often motivate a foreign investor’s choice to proceed with, shelve or cancel plans to invest in operations in a host country. When an MNC’s biggest rival is the host government itself, the political issues a foreign firm has to contend with necessitates the careful management of the highly sensitive issue of profiteering without alienating a host government (Fagre and Wells, 1982; Lecraw, 1984).

Political Risk Management

By making use of the model in Chapter 5 one is already starting to manage the possible political risks a foreign investment might face, by identifying and analyzing the severity and type of potential risks. The following section examines possible ways of managing political risks and the threats they might pose, including the integrative and protective management techniques that an MNC might use to manage the impact of political risk; political risk insurance; the formulation of a political risk policy; as well as political risk impact-probability management. The following section will also consider certain strategies that both governments and MNCs can follow in an attempt to reduce and manage not only the impact that political risk might have on a country’s investment climate, but also

the roles that both the MNC and the host government play as potential risk catalysts or agents.

Integrative and protective management of political risks

Two ways of reducing the impact that political risk might have on a foreign firm include integrative and protective techniques. Integrative techniques are concerned with reducing the frequency of loss and their main aim is to influence relations with institutions and actors in the political environment. Protective techniques are constructed to reduce the severity of loss and aim to protect the key internal strengths of the MNC (Gregory, 1988).

Integrative techniques aim at increasing the integration of the foreign venture into the host society – the premise being that the more integrated a foreign venture is, the less it will be perceived by the host country as being “foreign” to that specific environment. Examples of such techniques are policies dealing with local sourcing, distribution and employment; the sharing of ownership with the host government, local firms, and/or local citizens; careful selection and training of expatriate managers to ensure a cultural match; and cultivating close ties with government in an attempt to ensure some compatibility between the goals of the firm and the host government. However, the over-reliance on such integrative techniques can cause system-wide damage that will lessen the MNCs ability to compete effectively in both the world and host country markets. The strength of an MNC stems from its ability to engage in worldwide optimization and standardization, which enables it to realize efficiencies not available to a local firm (Gregory, 1988).

Protective techniques are designed to discourage host government interference, or in the event of interference, minimize the firm’s potential losses and generally provide for the non-integration of the foreign operations into the host country environment. But an over-reliance on these techniques may lead to a pattern of frequent loss, since the host government might identify such a firm as a potentially hostile entity despite the fact that such techniques will enable firms to reduce the severity of loss (Gregory, 1988).

Ideally, MNCs should attempt to develop a risk management strategy that includes both integrative and protective management techniques for every host country where the MNC operates. The use of integrative techniques will enable firms to respond to both the demands of a host country’s political environment and the opportunities that the environment presents. Additionally, protective techniques will aid firms in protecting their competitive strengths, and support them in minimizing the severity of loss should high levels of political risk occur and impact negatively on the profitability and operationability of MNCs.

Examples of integrative techniques used by firms include promoting good relations with host government; engaging in contractual and joint venture relations with host governments; careful expatriate selection and training; local sourcing; having a local partner with political connections; good labour policy; maximizing

the training of nationals of the host country; the issuing of equities with large firms; and export promotion (Gregory, 1988).

Protective techniques would range from financial techniques;³ to subcontracting and farming out blocks; vertical integration; withholding the technological edge if possible; maintaining full ownership (including technology); intra-company sourcing; and the diversification or globalization of large firms (Gregory, 1988).

Managing role players in foreign direct investment

There is a variety of role players involved in the decision making and implementation process of a foreign direct investment project. Chicken (1998), illustrates a way of managing all the role players and the likely outcomes of their actions by identifying them and attributing possible actions to each relevant party. In addition, Altier (1999) describes the steps involved in implementing the decision to "make" a direct foreign investment, and explains these steps as formulating the plan statement; identifying the objectives and stake-holder components of the plan; scheduling the events and times; revisiting the components and if necessary suggesting alternatives; performing objectives tests; redrafting the plan; and performing an analysis review.

Within the investment environment of a host country's manufacturing and industrial sector, the *role players* involved include the foreign direct investor, the national host government (in terms of regulators and planning authorities), local government, international authorities, international financiers, insurance, pressure groups, the public, and the media. As role players, these parties can also become potential factors of political risk as seen in previous chapters.

The *foreign direct investment project*, will involve project managers, consultants, financiers, contactors, and labour relations specialists in the decision making and implementation processes of the investment project. As their main functions, project managers, consultants and financiers will probably have the responsibility of proposing and implementing the investment project as such and solving any initial problems that may arise in that regard. The contractors will probably provide the services required for physically building the base of operations, and the labour relations specialists will be endowed with protecting labour interests (Chicken, 1998; Davidson and Haspeslagh, 1982; Kennedy, 1984; Kennedy, 1991).

On the part of *national government*, health and safety authorities will assess the proposal and inspect the installation to confirm that it satisfies national safety regulations, and pollution inspectors will assess the proposal and inspect the installation to confirm that it satisfies national environmental regulations. The planning authority will determine whether or not the installation is acceptable on the proposed site (Chicken, 1998). Safety and environmental regulations are often adhered to in the realm of *international guidelines* and within acceptable measures of, for instance, the World Trade Organization (WTO), the International Labour Organization (ILO) or the United Nations (UN).

International banks are also involved in a foreign investment project of magnitude in the sense that capital and funding is provided either directly to the foreign investment project, for example, or to the other financial institutions involved in the project (Alifano, 1984; Chicken, 1998; Euromoney, 1980; McCulloch, 1986; Suzman and Srivastava, 1986). Should political risk impact negatively on this project to the extent that it loses profitability and might even have to shut down, the project will default on servicing the capital funding extended to the project as such – in this case, political risks result in credit risk as well.

If the risks are acceptable, *insurance companies*, brokers and underwriters will provide cover against the potential direct and indirect losses the foreign investment project might face, including political risks if investors are advised to take out political risk insurance. *Public pressure groups*, like environmental pressure groups for instance, will most likely present their views on the acceptability of the proposal. The *broader public* might also either support or oppose the proposal, which can be augmented by the role the *media* plays in making the views that all the parties are expressing about the proposal widely known (Chicken, 1998).

The evaluation of the true total costs of investment risk in such cases must take into account not only the costs of technical and economic factors involved, but also those of socio-political factors that are important comprehensive risk factors to any foreign investment. Furthermore, evaluation of the total costs of investment risks should take into account the potential losses that *each risk* can result in outside the investment project itself, since the investment functions within a broader investment environment. This would include the implications for other parts of the industry and other parts of the polity and economy in general. It becomes clear that before there is real commitment to a project, there should be an audit of all the risks involved. This audit, like the method for risk analysis proposed in this book, should be aimed at identifying the whole spectrum of associated technical, economic and socio-political risks as well as their cost implications (Chicken, 1998; Davidson and Haspeslagh, 1982; Kennedy, 1984; Kennedy, 1991).

Possible economic risk factors pertaining to a host country include competition, terms of trade, export and import controls, taxation, economic instability, interest rates, exchange rates, cash inflow and the adequacy of capital supplies. Technical risk can be identified as being product adequacy for the specific host country market, production efficiency compared with competition within the specific industry, safety problems, environmental problems and supply problems. Socio-political risk will include legal constraints, employment regulations, contractual obligations, public opinion, national and international stability, protection against fraud, and political stability. These factors are explained in great detail in Chapters 4 and 5.

The internal risk factors within a company are usually characterized by the financial strength of the organization, the risks inherent in the company's operations and the size of the organization itself, including its workforce (Chicken, 1998). They include the firm's capability to supply the product, the financial strength of the project and the adequacy of the supply of its funds, operating costs,

costs of inputs and future plans as economic factors. Technical concerns include the question of internal conditions satisfying national regulations and requirements, if the quality of the product satisfies regulations and market requirements, and the development of new products. Regarding the socio-political factors inherent within the firms that might pose risks, the adequacy of the workforce and internal organization; protection against fraud; adequacy of training programs; and problems with the general public feature very strongly. In identifying the abovementioned risks, a very important first step has already been taken in managing an investment project at the pre-contract phase, bearing in mind that the required scope of risk assessment changes at each stage of the investment project (Chicken, 1998; Davidson and Haspeslagh, 1982; Kennedy, 1984; Kennedy, 1991).

At the pre-contract phase, all the technical, economic and socio-political factors are identified and assessed, and acceptable solutions to possible problems are developed. The assessment, for which a model can be used like the one in Chapter 5, should attempt to identify all the problems that have to be solved in order to bring the project to fruition and operate successfully. Another important function of the risk assessment is to identify the total cost of the project and the time-scale in which funding might be required. Once the decision has been made for the foreign investment project to go ahead, the constant monitoring of risks becomes increasingly important. During the "implementation to operation" period of the foreign investment, the concern of the monitoring function will be to monitor the accuracy of the initial risk assessments. Once the project is in operation, the concern of the risk monitoring process will be to monitor changes that may develop in either the internal or external environment of the project, in case the project should be modified or even abandoned (Chicken, 1998; Davidson and Haspeslagh, 1982; Kennedy, 1984 and 1991).

Even at the end of the project and after many years, risk assessment will have to determine the magnitude of the risks that an organization might still have to deal with. These might include paying the difference after corporate tax hikes; paying fines for environmental damage; paying back initial loans, pensions, or claims against the project for harm suffered; the cost of leaving the site clean or even maintaining the safety of a contaminated site such as a metallurgical or chemical plant for an extended period of time.

Ways in which host governments can contribute to a favourable investment climate
Porter (2000) and Mahini (1988) maintain that a host government's "proper role" should be that of catalyst and challenger – to encourage both domestic and foreign companies to higher levels of competitive performance. Host governments should not hamper the transmission of the positive factors of demand; factor conditions; related and supporting industries; firm strategy, structure and rivalry as discussed previously. In situations where such factors are restricted by government policy, higher instances of political risk would probably be measured. Indirectly, government can stimulate or hinder the conditions that motivate foreign companies within host countries to strive toward higher levels of competitiveness.

Competitive time for companies and political time for government also differ, and only in investment climates where the two are reconciled, are relatively low levels of political risk present. Porter (2000) explains that it often takes more than a decade for an industry to create a competitive advantage, as the process entails the long upgrading of human skills, investing in products, and processes and penetrating foreign markets. In politics though, a decade can be an eternity. Most governments, notably those governing developing countries under popular governance, favour policies that offer easily attainable short-term benefits that are not necessarily responsible options. These benefits might refer to subsidies, protection, and arranged mergers which are unfortunately the same policies that might in fact delay long-term innovation and competitiveness.⁴

In order to avoid such a direct contribution to potentially higher levels of political risk, Porter (2000) suggests, in the following discussion, some basic principles that a host government can embrace in order to play a supportive role in creating a favourable investment climate and eventual national competitiveness. In their most basic sense, these factors include focusing on specialized factor creation; avoiding intervening in factor and currency markets; enforcing strict product, safety, and environmental standards; sharply limiting direct cooperation among industry rivals; promoting goals that lead to sustained investment; deregulating competition; enforcing strong antitrust policies; and rejecting managed trade.

Specialized factor creation Governments, even more so governments of developing countries, have the critical responsibilities for fundamentals like the primary and secondary education systems, basic national infrastructure, and research in areas of broad national concern such as health care. Although industrialized countries have “graduated” from these material issues to more post-material issues, developing countries still face many difficult challenges in fulfilling even these fundamental responsibilities.

Mechanisms that ultimately create the factors that yield competitive advantage are specialized apprenticeship programs, research efforts at universities connected with an industry, trade association activities, and most importantly, the private investments of companies. These specialized factors of competitive advantage creation are more likely to be apparent in countries with low levels of political risk. The sentiment that political risk mostly occurs in developing countries can be based on the notion that governments in developing countries are either struggling to meet the fundamental responsibilities of primary governance, or lack the political will to see these responsibilities met.

Non-intervention in factor and currency markets By intervening in factor and currency markets, governments probably hope to create lower factor costs or a favourable exchange rate that will help companies compete more effectively in international markets. Yet these policies are often counterproductive and work against the upgrading of industry and the search for more sustainable competitive advantage.

Product, safety and environmental standards Strict government regulations in this regard, but not irrationally so as to create the idea of enforcing protectionist non-tariff barrier policies, can enhance a country's investment climate by stimulating and upgrading domestic demand. Stringent standards for product performance, product safety, and environmental impact pressure industries to improve quality, upgrade technology, and provide features that respond to consumer and social demands. The adherence to such government regulations by industries is also a measure of policy penetration on the part of government, where it follows that the policies of a legitimate government are likely to be more penetrative and the consent to be governed by a legitimate government is more likely to be higher in countries with lower levels of political risk.

Limited direct cooperation within industries In the belief that independent research by rivals is wasteful and duplicative, that collaborative efforts achieve economies of scale, and that individual companies are likely to under-invest in research and development because they cannot reap all the benefits, governments often embrace the idea of more direct cooperation. But companies rarely contribute their best scientists in such cases and usually spend more on their own private research in the same field. Typically, governments only make modest financial contributions to cooperative projects. This becomes problematic in developing countries once again, where research is needed in the fields of primary health care for instance, to enable the fight against preventable illnesses. The health of a labour force, and thus the quality of social capital in a host country, greatly impacts upon the investment climate a country is perceived to offer. Yet under certain limited conditions, cooperative research can be beneficial, provided projects are in areas of basic product and process research and not in subjects closely connected to an industry's sources of advantage. Cooperative research should not be enforced or prescribed and should only be indirect, channeled through independent organizations to which most industry participants, including foreign operations, have access.

Promotion of goals that lead to sustained investment Government plays a vital role in shaping the goals of investors, managers, and employees through policies in various areas and should aim to encourage sustained investment in human skills, innovation, and physical assets where MNCs are also agents of such kinds of investments. One of the most powerful tools for raising the rate of sustained foreign investment is a tax incentive for long-term capital gains of five years or more.

Deregulation of competition Regulation of competition through policies of maintaining a state monopoly, controlling entry into an industry, or fixing prices is not only a political risk, but can also have strong negative consequences. Profitability and innovation are stifled as companies become more preoccupied with dealing with regulators and protecting what they "already have". This can

render the industry less dynamic, less desirable to buyers and suppliers, and ultimately makes the investment environment less attractive to foreign investors.⁵

Reject managed trade Rather than promoting innovation in a nation's industries, managed trade could result in an investment climate conducive to inefficient companies. Government trade policy should pursue open market access to every foreign nation. Trade policy should not be a passive instrument – it should not exist merely in response to complaints or work only for those industries that have enough “political clout”. Such policy should not have a long history of injury or defensive policy retaliation, nor should it serve only industries in distress. Trade policy should seek to open markets and at the same time address emerging industries and initial problems.

Ways in which MNCs can appease (host) governments The challenge is to create global competitive advantage by operating in foreign countries whilst managing potential political risks that might impact negatively on MNC profitability. On the one hand, an MNC's strategic challenge is to exploit the sources of global competitive advantage without succumbing to the potential threats that higher levels of political risk in a host country might pose, and on the other hand to avoid being itself an agent of political risk. These sources of global competitive advantage are national differences as well as scope and scale economies, and can be utilized by an MNC in order to optimize global efficiency and international flexibility as well as worldwide learning (Bartlett and Ghoshal, 2000; Porter, 2000).

Furthermore, the successful global competitor manages its business in various countries as a single system, not as a portfolio of independent positions. The most obvious leverage an MNC obtains from a host country market is the volume that market contributes to the company's overall effectiveness (Hout, Porter and Rudden, 2000).

Create pressure for innovation Part of an MNC's foreign investment strategy should be to take benevolent advantage of the host country in order to create an impetus for innovation. MNCs can sell to the most demanding and sophisticated buyers and channels; seek out those buyers with the most difficult needs; establish norms that exceed the toughest regulatory hurdles or product standards; source from the most advanced suppliers and treat their host country employees as permanent employees in order to stimulate the upgrading of skills and productivity.

Seek out the most capable competitors as motivators The best managers respect and study their competitors. In order to stay dynamic, MNCs should make the meeting of healthy challenges part of the company's norm. Lobbying against strict product standards indicates diminished management aspirations. In the same sense, government officials lobbying against stricter oversight regulations indicate the possibility that political will is lacking in such an official, as is the will to follow norms and standards.

Establish early warning systems MNCs can take actions that assist them to see the signals of change and act on them, thereby getting an advantage on the competition. Just as the model presented in Chapter 5 enables analyzing and anticipating policy changes that might impact negatively on the profit-taking of foreign investors and even possibly operating functions, MNCs can find and serve buyers with the most anticipatory needs, find investment climates or host countries where regulations foreshadow emerging regulations elsewhere, bring some “outsiders” into the management team and, as an example, maintain ongoing relationships with research centres.

Contribute to improving the national investment climate MNCs have a direct interest in making the host country investment environment a better platform for success. Part of their responsibility in this regard is to play an active role in working with buyers and suppliers in supporting them to upgrade and extend their own operations. The health and strength of host country industries will only enhance the MNC’s own rate of innovation and eventual competitive advantage. Leading companies also take explicit steps to create specialized forces like human resources, scientific knowledge or infrastructure. MNCs can also hasten innovation by putting their operations where there is a network of sophisticated buyers, important suppliers, or specialized factors-creating mechanisms, such as universities or laboratories.

Welcoming domestic rivalry Managers complain easily about excessive competition and argue for mergers and acquisitions that will produce economies of scale and critical mass. Yet in the long term, industry rivalry contributes to the creation of sustainable competitive advantage. It is more advantageous for a foreign company to supplement home-based disadvantages than merge with leading host country competitors. Tapping into selective advantages in other countries in a responsible and sensitive manner can contribute to creating and sustaining a competitive advantage.

Political risk insurance

Firm’s purchase insurance to protect themselves against property and casualty losses, and against product liability suits. Apart from private insurers, government sponsored agencies (like the American Overseas Private Investment Corporation, OPIC) and multilateral organizations (like the Multilateral Investment Guarantee Agency, MIGA) provide insurance that protects foreign direct investments against expropriation of assets, civil strife, war, and currency inconvertibility.

Obtain political risk insurance is perhaps the most common form of risk management. This type of insurance is available in both public and private sectors and is widely held by international investors and businesses. OPIC insurance was originally provided under the auspices of the United States Agency for International Development (USAID) and supports the argument that political risk

need not lead to limitations on investment. Risk analysis offers advice to the investor on how to manage risk in a world full of political and social danger but which is also full of extraordinary opportunity. OPIC's level premium rates for all countries covered are an indication that international investment is being encouraged, despite the difficulties to be faced. Both risk averse and risk assertive investors are not necessarily avoiding risk but are taking advantage of the knowledge gleaned from political risk analyses to deal with societies in the same manner that investors would deal with economic or financial uncertainties. Political risk analysis and political risk management are therefore intricately and intimately intertwined.

Private political risk insurers Investments are often made on the agreement and purchase of an operating license or concession. If that agreement is cancelled in any way or contractually changed, the investment itself may no longer be of any value. Requirements for insurance clauses to counteract any such governmental measures are growing and are proving to be all the more effective. Changes to a license or concession can be a method utilized by governments to remove what they may see as competition and can thus effectively result in a form of expropriation (or creeping expropriation – a protracted form of expropriation over time), albeit allowing the investor to retain title to an asset that no longer retains its economic feasibility (Alifano, 1984; Dealmaker, 2002; Euromoney, 1980; Kennedy, 1991; Moran, 1998). Other “add-on” clauses, such as forced abandonment and forced divestiture have proved of interest to investors and financiers, especially in the light of internal problems in areas such as Indonesia over the past few years (Venter, 1999).

Political risk insurance can also be obtained from the following private political risk insurers, and a few mentioned here include AIG Global Trade and Political Risk Insurance Company, FANDZ International Law Group, Marsh Private Equity Mergers and Acquisitions Services, Meridian Finance Group, City South Limited, Provident Traders, Inc., BINKS Insurance Brokers Limited, Stening Simpson Group, Lex-Tek International, Export Insurance Services, Inc., Coface Ireland, and Managing Agency Partners.⁶

Formulating and designing a political risk policy

The lack of literature on political risk policy formulation was not viewed as a limitation. The introduction of this notion was rather seen as a challenge. Not planning for political risk implies a degree of ignorance of local conditions in a host country; insensitivity to possible changes in the particular industry's investment climate both in and outside of the host country; and a lack of acknowledging the relevant stakeholders in decision making processes, be they MNC employees, the host government, or the broader public.

An MNC can draft and uphold an independent policy on the way in which it views, experiences, hedges and manages the political risks with which it either deals on a daily basis or might see as potential risks in future. Managers of foreign

operations in host countries should have a political risk policy that explains to the organization and the host country how the MNC aims to deal with possible political risks. Every MNC or foreign enterprise should draft a political risk policy in the early planning stages, and amend this policy throughout the post-analysis implementation phase (or abstention phase, if it is felt that the investment should be shelved until certain monitored conditions change).

A political risk policy or strategy for an organization includes a design of the operation and subsequent governance of the organization in its environment. In this case, it would be the investment climate of the industry and the host country, as well as the international investment climate itself at any given time (Bunge, 1998). Most managers of firms implement already established corporate policy and rarely inquire into the nature of such a policy. Such neglect is unwise, as sudden and even expected changes in the policy environment of a host country, changes in technology, social structure, national legislation, public attitudes or even the international environment may require drastic and swift policy and strategy changes.

The goal of a political risk policy should be to assist the foreign organization in laying down its specific role(s) in managing political risks by applying suitable organizational principles and techniques. These might include how potential political risks are to be identified, assessed, measured, monitored and anticipated in future. Of course, the main goal of an MNC is to make profit. But this primary goal need not be incompatible with adhering to the national laws of a host country nor with employment equity practices and programs for investment in human capital. In order to avoid product boycotts or demonstrations, an MNC can be a socially beneficial organization in the sense that, for instance, it contributes to the social quality of a labour force or by delivering useful commodities at affordable local prices for domestic consumption. In light of tripple bottom lining, an MNC will also reduce the political risk it might be perceived as posing to a national government by combining profit with service and performance accountability (Bunge, 1998).

From the discussions so far it should also become clear that political risk is not "aimed" at foreign companies operating in host countries. It is not only a host country's investment climate and policy environment that poses political risks to foreign investors. The MNC itself can pose accompanying political risks and should guard against being perceived as an agent of political risk. An important point to bear in mind is that an MNC is by definition foreign to a host country. It operates in social, political, societal and economic conditions that differ by varying degrees from those of the home country. An MNC's political risk policy is most probably based on the firm's global strategy, and in guarding against being a political risk itself, MNCs should consider the way in which the local culture will interpret an MNC's investment strategy – if it is acceptable (although different from what was originally intended), and if the MNC has the commitment and patience to follow through with its global strategy and associated political risk policy (Lane, DiStefano and Maznevski, 2000).

Responsible managers of MNCs, especially when dealing with political risks, should not rely on improvisation, but rather plan ahead, monitor, forecast, anticipate and budget so that, in case the anticipated political risks might hit, the MNC will "survive" the risk situation short of divestiture. Political risk management entails the constant updating of these plans in an attempt to adapt the organization to internal and external socio-political and socio-economic changes, and in doing so, favour robust over rigid planning – assuming that MNCs have the resources (financial and human) to plan and act with flexibility (Bunge, 1998).

Large corporations do not merely forecast risk in anticipation thereof but plan in the event thereof – setting their goals, designing scenarios, conducting analyses, and monitoring their operations actively. Some organizations are less successful in such an endeavour, often due to having a more hierarchical and ethnocentric structure within a host country, as a consequence of which their plans and policy making processes exclude participation and criticism, are based on insufficient local knowledge and are rigid rather than adaptive. Organizational and management rigidity is often unavoidably concomitant with excessive size and centralization, as both lean toward inactivity, bureaucratization, alienation and squander.

Bunge (1998, p.400) reiterates an earlier point that business, economics and politics cannot be separated from one another, by explaining that "[e]veryone knows that business is conducted not in a political vacuum, but in close interaction with the body politic". He goes on to explain that it is no secret that politicians, statesmen and civil servants are beleaguered and tempted by business lobbies and that political campaigns are occasionally funded by corporations expecting reciprocity. In a political risk policy, it is advisable to include an organizational code of conduct regarding the issue of interaction between business and politics. Such interaction is bound to be synergetic at times and confrontational at others.

In a policy for political risk management, provision should be made for the right to influence macroeconomic and social policy makers, though as the privileged party, not secretly but openly and in concert with labour and consumer groups. Eventually, more is to be gained from an average but fair deal than from huge profits obtained through crafty deal-brokering (Bunge, 1998).

Elements of a political risk policy Apart from the use of the model in Chapter 5 as a means of identifying potential client- and/or industry specific investment risks and planning for political risk management, there are some guidelines that can be considered when compiling a political risk policy for an MNC (Lane, DiStefano and Maznevski, 2000). These guidelines should be adapted to every specific host country, even for the same MNC. They contain measures of flexibility that should enable an MNC's political risk policy to deal with changes in less stable policy environments and investment climates.

Firstly, the stakeholders that have an interest in, or will be affected by the foreign operation are identified. Stakeholders could be the shareholders, the home country government, the host country government, customers, suppliers, employees, natural resources and the physical environment, as well as trade unions.

In this process, the stakeholders and their interests in the foreign project can be comprehensively identified.

Once the stakeholders have been identified, the MNC's responsibilities and obligations to these stakeholders can be analyzed. Where MNC actions can influence or spark political risks such as demonstrations and boycotts, it is important to remember that MNCs have multiple groups of shareholders in addition to their own investors in the firm. Apart from the economic, managerial and legal decisions, managers also have to consider any ethical issues that might be linked to different religions and cultures in different host countries.

In formulating a political risk policy, the third step makes provision for the constant monitoring and analysis of a host country's policy environment, specifically with regards to the impact its policies might have on a specific industry's and host country's overall investment climate. Unsubstantiated assertions posing as policy analysis might result in MNCs adapting political risk policies to political and policy rumours, which in doing so, may be to their detriment. The consideration of multiple and even opposing viewpoints should be provided for, but examined carefully. The costs and benefits of any MNC (in)action to all stakeholders should be weighed with great attention to detail.

Fourthly, it should be considered whether there are options the MNC has not yet identified. In trying to identify possible action, the MNC should avoid characterizing decisions using false dichotomies, like either/or characterizations that do not have to be win/lose positions. The statement "We need to pay the bribe or lose the license" portrays a situation as win/lose, but this does not necessarily have to be so. Such a position might be the result of initial analysis not being as complete as it could have been. An MNC should attempt to strive for win-win situations when composing a political risk policy. An attempt has to be made to find a way of solving a problem that satisfies all parties involved and allows the MNC to fulfill its private and public obligations. Obligations to stakeholders include among others, meeting the expectations of national government, policy makers, labour unions and environmental lobbyists, without losing sight of the MNC's own goals.

As a fifth guideline to bear in mind when formulating a political risk policy, "culture" should not be used as an excuse for not trying to "do things the proper way". Decision making criteria that should be included in this instance are doing the best for all stakeholders involved, fulfilling obligations, observing local and national laws as well as contracts, not being deceitful, and avoiding physical, social, political and economic harm to a host country. An MNC should also observe in its political risk policy a constant attempt at leading the way in the area of global, social and political responsiveness and accountability.

The aim of a political risk management technique, like formulating and following to a political risk policy, is to reduce a firm's exposure and vulnerability to political risks without having to drastically change the firm's strategy.

Avoidance of political risk occurs when management considers the risk associated with operating in a given country to be unacceptable. Risk avoidance involves exiting through divestment of the assets and capital that were committed

to a specific host country. For a firm not yet participating in a certain industry and market within a host country, avoidance implies postponement of market entry until the political uncertainties or risk factors within that specific industry decrease to acceptable levels. A strategy of participating in only low risk environments is a primary facet of risk avoidance (Miller, 1991).

MNCs may also seek to control important political risk factors in order to reduce the impact they might have on the firm as such. Such control strategies can include political activities (lobbying for or against laws, regulations, or trade restraints), or gaining market power or undertaking strategic moves that threaten competitors and governments into more predictable behaviour patterns. This is an aggressive strategy and the grasp that large MNCs have on host governments of developing countries might only serve to worsen the reputation MNCs have of holding government policy hostage (Miller, 1991).

On the other hand, cooperation can be distinguished from controlling political risk in the sense that cooperative responses to political risk involve multilateral agreements, rather than unilateral control as a means of managing possible political risk. Cooperative strategies of managing risk include long-term contractual agreements with host governments; voluntary restraint and compliance with host country laws and regulations; and alliances or joint ventures with domestic firms or even with the host government (Miller, 1991).

A further strategic response to political risk that can be incorporated in a firm's political risk policy is managerial moves to increase organizational flexibility within a host country. This involves the MNC's ability to adapt to substantial, uncertain, and swift policy changes that might have a meaningful impact on a firm's performance in a host country. Flexibility increases when firms actually decrease the cost of organizational adaptation to deal with political risk factors. Unlike control and cooperation strategies that attempt to increase the predictability of important political risk factors, flexibility responses increase a firm's internal responsiveness while leaving the predictability of political risk factors unchanged. Geographic diversification and multinational production, as well as flexible input sourcing, labour force size and skills, and the flexibility of plants and equipment contribute to a firm's attainment of a robust risk management strategy (Miller, 1991).

A political risk policy can prove to be a truly valuable instrument for an MNC within a host country. The fact that a firm has such policy guidelines is already an indication to the host government and the host society that an MNC is aware of its status in a foreign country, and that it can potentially influence a host country's policy environment and overall investment climate to a greater or lesser degree.

Political risk impact-probability management

Despite a firm's best efforts to anticipate, measure and calculate political risks that a foreign investment might face, minimizing the impact of unforeseen risk and balancing the consequences of risk on a given project remains the primary concern of risk management and control exercises.

A political risk impact-probability analysis for an investment project can be completed for the host country's investment climate as a whole. The main role players in this climate, apart from government (in)actions as already established, include competitors, economics and the markets as such. Each risk factor in Chapters 4 and 5 can be arranged according to its probability of occurring and the impact its occurrence might have.

In a typology explained by Jennings and Wattam (1998), its application to political risk management can be realized. Four probabilities are identified and means of action are offered. For the purpose of political risk management, these probabilities of political risk impact are established after political risk analyses have been conducted and can be illustrated as follows:

Probability of risk	High	A High probability/low impact	B High probability/high impact
	Low	C Low probability/low impact	D Low probability/high impact
		Low	High
		Impact of risk	

Adapted from Jennings and Wattam; 1998, p.179

Figure 6.1 Political risk impact-probability

In case A, the impact of political risk is usually acceptable and it will not be cost effective to take any preventative action although the probability of risk is relatively high. Despite the probability of political risk being relatively high, the "types" of political risks that are relevant in this case are of a "low-impact" nature. The political risks are probably manageable by adhering to a political risk policy that contains contingency plans and that is flexible to adapt to changes in the investment climate on short notice. Such political risks would not include expropriation or forced abandonment, for instance.

In case B, due to the potentially damaging impacts that political risk might have on the organization or the project, contingency plans should be prepared and the input (financial, human resources, time) into making these plans will be relatively high. This type of foreign investment should only be pursued if the political risks are manageable and if resources (financial, human resources, time) are made available either through capital budgeting or financing. Due to the high probability

of political risk occurring with relatively high impact risks, investment should be pursued if adequate insurance coverage has been extended to the project; if the benefits of investment success will far outweigh the degree of political risks faced; if management is experienced and able to organize in such an investment climate; and if the resources necessary for the project's function can not be found anywhere else.

In case C, where the probability of political risk occurring is low as well as the impact those political risks might have, the management of these political risks can be conducted at a relatively low cost to the MNC with the aid of a political risk policy and a contingency plan. Whether or not any action is taken will depend on the cost effectiveness of the action as such, as the probability and impact of political risks does not warrant such extensive actions as in case B.

A case D situation can be particularly disconcerting to an MNC. In such a case, although the probability of political risk occurring are relatively low, the impact that such a threat might have on the odd chance of it occurring, is high (expropriation, forced abandonment, repudiation of contracts, or the cancellation of licenses). Action must be taken to not only enable the avoidance of impending political risks, but also the recapitalization of losses.

By evaluating these cases, the most effective political risk control mechanisms can be selected in the post-analysis phase, thus allowing amendments to be made to an MNC political risk policy or capital budget, should something go wrong. Risk can thus be minimized by *reducing the impact* that it might have on a project by looking for contingency or alternative methods of provision for the project. It follows that risk is associated with the ways of solving or providing a solution and implementation for change in a project's approach or planning for risk and its eventualities. By being aware and informed, and by evaluating the associated risks, the problem domain is explored and the consequences of success as well as of failure can be known and understood (Jennings and Wattam, 1998).

The human factor In all of the above cases, apart from financial and physical capital, human capital (human resources) also plays a large role in the sense that MNCs employees at all levels that actually drive the operation. They can either be employed as locals from the host country, or can be expatriates. The operations of an MNC in a foreign country are very dependent on its personnel of which many individuals are often repatriated from the MNC's home country.

Expatriate managers of MNCs in host countries often find themselves especially torn between an allegiance to the parent firm and their allegiance to the local foreign operation (Black and Gregersen, 1992). Faced with this dilemma, expatriate managers end up directing their allegiance too far in one direction or the other, and this in itself can pose serious risks for MNC operations in a host country as it creates costs and consequences for both themselves and the organization. Additionally, the high competitive pressure, geographical distances, and wide cultural diversity of global operations combined with ineffective management by expatriates, can set off a cycle that erodes or might even destroy an MNC's global

competitive position, the ramifications of which can actually result in heightened levels of political risk.

Black and Gregersen (1992) explain that this cycle starts with an unbalanced allegiance that can lead to a variety of failures during and after international assignments. As managers hear about these failures, firms find it increasingly difficult to attract top international candidates, producing worse organizational results and/or failed careers. This further limits the pool of willing and qualified candidates and, over time, the firm's international competitive advantage erodes.

The political risks inherent in such a downward spiral probably become more apparent by the time an MNC's competitive advantage starts to wane. By the time profitability declines, MNCs start to take chances by diverting from their planned global strategy and political risk policy. This might take place in the form of bribing government officials to ensure contracts; defaulting on loans; not being able to honour contractual deadlines tendered and contracted for; cutting wages of employees; tax evasion; slackening labour and safety regulations; hiring unqualified personnel in order to pay lower wages; defaulting on quality controls and environmental regulations; and ignoring industry policy and government regulations for the sake of remaining operational among drastic losses in competitive advantage and profitability.

It follows that, when an MNC becomes a threat in a host country, host governments might retaliate by shutting down its operations because of irregular practices. Its contracts might be cancelled or licenses revoked. Labour unions might call local employees to strike, thus augmenting losses even further by losses in man-hours and productivity. Legal action might be taken against MNCs that are disregarding environmental regulations, resulting in national policy changes or even possible hikes in corporate taxes and fines to recover damages. National laws might even be amended by the national legislature in order to ensure that such practices do not happen again. A host country's attitude toward foreign investment might be negatively influenced and may heighten the level of political risks for future investors, illustrating how an MNC itself can impact negatively on a host country's investment climate.

Selecting the "right people" for the specific positions within the MNC in a certain host country, training them, and sending them (and their families) to their foreign posting is only the first step. What might also become problematic is reintegrating these employees into the company after the foreign assignment so that the company can continue to benefit from their international experience and expertise. The international assignment may be an important vehicle for developing global managers; achieving strategic management control; coordinating and integrating the global organization; and learning about international markets and competitors, as well as foreign social, political and economic situations. Yet employees that have benefited from such assignments need to be re-acclimatized and repatriated with care in order for the firm to take advantage of their unique background (Lane, DiStefano and Maznevski, 2000).

Concluding Remarks

In managing the complexities involved in making decisions regarding foreign investment and then implementing these decisions, the idea is to develop some definition of the problem that is to be tackled, without losing sight of the relationship between the problem itself and interrelated factors that may or may not impact on the implementation of such a decision. By identifying the political risks that are contained in the implementation of a foreign investment decision through political risk analysis, structure is given to the complexities of the decision and, in so doing, one becomes familiar with the risks involved and uncertainty can thus be reduced.

Although a political risk analysis or assessment is a first step in giving substance to a foreign investment decision, it is also a way of managing the political risks involved by identifying them. The structuring of the complexities contained in an investment decision carries on throughout the life of an investment project or operation. Even after implementing the investment decision, setting up operations or starting the factory, the management of the investment risks never ends. Political risk analysis is a constant given throughout the life of a foreign investment – an assessment constantly explores, identifies and questions the levels and nature of the political risks involved in a project. It enables analyses and reflects on the most suitable way of continually managing political risks by means of any of the abovementioned approaches, or as a combination of those strategies and techniques.

Notes

- 1 Bargaining takes place for concessions, licenses, contractual agreements, remittance allowances, tax concessions and tenders.
- 2 Corporatism implies that bargaining takes place between government, business and labour.
- 3 These range from involving other companies in a project, even though the profit will be less, maximizing debt financing, raising capital from various international sources, maintaining a certain ratio of internationally funded projects, refusing to bid on large projects in countries with high debt ratios and entering new countries in gradual steps.
- 4 Deregulating a protected industry, for example, will lead to bankruptcies sooner, and to stronger more competitive companies only later.
- 5 Deregulation and privatization will not succeed without vigorous domestic rivalry that requires a strong and consistent antitrust policy.
- 6 See <http://marshcredit.com>, <http://tradecredit.com>, <http://www.fandz.com>, <http://www.meridianfinance.com>, <http://www.csibrokers.com>, <http://www.providenttraders.com>, <http://www.binks.com>, <http://www.steningsimpson.com>, <http://www.lrx-tek.com>, <http://www.exportinsurance.com>, <http://www.coface-ireland.com>, <http://www.mpaunderwriting.com>.

Chapter 7

Summary and Concluding Remarks

In order to design a comprehensive model for political risk analysis, one has to think of how to go about measuring something as elusive as political risk. The book started out by establishing the context of political risk and explained what it entails, what other authors think it means, and even more importantly, what it does not mean. Once the book established a conceptualization of political risk, it became necessary to start thinking about how one could measure it.

If political risk supposes the probability that a certain event or factor might impact negatively on the returns of foreign investment, it further suggests *a degree of impact that governmental policies or societal action, originating either within (internal risks) or outside the host country (external risks), can have on foreign business operations and investments.*

There are a myriad of factors, each with its own risk indicators, that can cause political risk and depending on how severe these factors are, the level of political risk these compounded factors constitute. Because the presence of these factors point toward the possibility that a potential for the occurrence of political risk exists, the severity or degree to which they are present in a country can be measured by factor indicators because they indicate, or point toward, the probability that political risk might occur.

For these risk factor indicators to represent something, the book set out to correlate the measured values of the political risk indicators to the degree of political risk, the level of risk present, or the “size” of the probability that risk might occur. This was not always easy, especially because in the first instance, one often had to measure things there were no values for. It was relatively easy to incorporate quantitative economic values like the balance of payments, interest and inflation rates, or the average percentage with which wages have either decreased or increased in a given year – but measuring the militancy of labour or government legitimacy was a completely different and very challenging task. Also, “a lot” of one kind of risk factor was not always necessarily a bad thing as “a little” of another was not always a good thing. For example, “a lot” of illiteracy is surely not a good thing; especially when one thinks about the consequences of illiteracy and the contribution thereof to potential levels of risk. In the same sense, “too little” political will is not a good thing either, whereas “too little” inflation or a decreasing budget deficit is not necessarily a bad thing.

Once one starts to think about political risk factors and their indicators and how to “weigh” them, the kind of model that can be designed becomes clear. After being convinced that it is possible to allocate numerical value to “soft” risk factor indicators by explaining their implications, and weighing each indicator on an

individual scale, it is feasible to build a model that makes it possible to measure and calculate the real percentage chance that political risk might occur. The reason for wanting to measure the degree of political risk is not only to analyze risk and be able to recognize its presence and anticipate it, but to very importantly, also create the ability to manage the impact of political risk in cases where it could not be completely avoided.

The principal purpose of this book is to present a way of being able to anticipate political risk and the consequent goal was to suggest means of managing these risks. Chapters 5 and 6 aimed to address these purposes, where the management of these risks can either be conducted in a broad fashion, or whittled down to suit specific investments or operations. Other uses for political risk analysis were also mentioned, like conducting both country specific and comparative analyses. The model for political risk analysis presented in this book hopefully alleviates at least some complexity of a decision making environment regarding foreign investment. Although uncertainties surrounding the validity of political risk analyses still relate to the skepticism experienced when measuring qualitative variables, this book tried to aid in compounding a better understanding of the magnitude of political risk by showing how multi- and inter-disciplinary the practice of its analysis truly is. Political risk scholars concur that such risk is affected not only by political, social and economic phenomena, but also by environmental and socio-cultural factors, and also agree that these factors should be incorporated into a variety of frameworks to enable the assessment of political risk in a specific country or industry.

It is irresponsible to present a potential investor with a risk assessment that does not incorporate political risk factors and their indicators, let alone environmental, societal and socio-economic indicators. Ultimately any business climate, regardless of the country being studied, is underwritten by a political climate and political culture of the system in which foreign operations wish to operate profitably.

What is often labeled as unnecessary and irrelevant detail in risk analysis often results in a lack of using micro risk factors and their indicators and an underestimation of the importance of such micro risk indicators. Hopefully this book did indeed take up the challenge of showing that political risk analysis can be made more precise.

The Conceptualization of Political Risk

In reading about research in the field of political risk analysis, it becomes clear that many authors begin by noting the diversity and the discrepancies of its existing definitions, but evidence in political risk insurance shows that the major perceived risks investors insure their interests against seem to be confiscation, expropriation and nationalization. In light of this book's findings though, a case can be made for urging that political risk insurance clauses be extended to further include any or all of the micro risk factors that have been identified to ensure that political events do

not impact negatively on a foreign company's profitability. The cost of such insurance can also be scaled to the result of an analysis like the kind made possible in this book, where a real percentage probability can be calculated. Thus, a percentage relating to that of the calculated probability of risk occurring can be used to calculate risk coverage as a percentage of the overall cost of capital investment.

This book also tried to clarify some of the confusion relating to the respective natures of political and country risk. Country risk differs from political risk in the sense that country risk can be explained as potential financial losses due to problems arising from *macro-economic* events in a country that are uncontrollable yet often inevitable. Political risk, on the other hand, recognized as factors caused by government policy (in)action or reaction, can to some extent be managed if not avoided.

As Figure 2.1 illustrates, a country might be willing to repay loans (low political risk) but may not be able to do so (high country risk). This does not necessarily point toward a political risk situation as much as it does to an amalgamation of various credit difficulties, but a case of low country risk combined with high levels of political risk needs to be scrutinized. What has been shown in the second chapter though, is that political risk and the analysis thereof cannot be adequately conceptualized without expanding on its link to country risk.

Although easy to use interchangeably, political risk should be appreciated as being distinct from political instability and political uncertainty, where political instability can be seen as an indicator that points toward the possibility of risk occurring. The underlying risk that political instability holds for a foreign organization is the possibility that political disequilibrium might result in regulations hampering the escalation of profits, or limits on profit taking.

Political risk is present in both macro and micro environments. Although macro political risks are "types" of risk that affect operations throughout an entire country, micro type risks affect only some businesses in different ways, or some more than others. Also, it is not only the host country that poses risks to investments, but the type of foreign investor and the nature of the foreign investment itself can also present the foreign transaction with certain risks.

Although political instability and political uncertainty are mentioned as contributing factors to levels of political risk, uncertainties can on occasion be regarded in a positive light. In some cases, "less than positive" results of a political risk assessment can even encourage certain investment endeavours in risk assertive investors. This is why a model of political risk assessment should enable comparative analyses – in order to compare the results of different country risk profiles and eventually select the most positive post-analysis result as an investment opportunity in consultation with investors on an individual basis.

Political Risk: In the Final Analysis

In offering a method of analysis for political risk, this book not only describes

political phenomena in terms of the factors of political risk, but also tries to explain or understand the occurrence and recognition of risk in future. Political risk analysis aims to interpret something in terms of its effects – it is a process in which investment potential is measured against the backdrop of certain factors which contribute to the levels and type of political risk present in a certain country.

A working definition of political risk *analysis* broadly encompasses the assessment of the possibility that factors caused or influenced by government political decisions or other unforeseen events in a country will affect business climates in such a way, that investors will lose money or not make as much money as they expected when the initial decision to investment was made.

Although both internal and external events contribute to the occurrence of political risk and are constantly influencing the severity and degree to which risk factors influence investments, “good” political risk analysis necessitates a careful regard of the specific issues that are relevant to every individual organization considering potential foreign investment opportunities. The choice of tool for each political risk analysis should thus be chosen with care. A generic model of political risk analysis can assist in cross-country comparisons for instance, but should be adaptable to suit a specific client’s needs in an attempt to assess industry specific micro risks within the host country’s macro environment.

Once conducted, a political risk analysis draws the potential foreign investor’s attention to the problems that risks might pose to investment viability. Where political risk analysis is a first step in decision making regarding foreign investment optimization, analyses focus on problems that call for the making of decisions concerning the implementation of actions (risk management), and in a way, already start the process of dealing with problematic and complex decision making.

By conducting a political risk analysis, one is already managing risk. By studying and understanding the political risks involved, the analyst is able to advise an investor in terms of changing or adapting investment decisions by continually monitoring the impact identified risks might have on a certain investment – thus controlling the influence risks might have on consequential losses in profitability.

Circumventing the Problems of Political Risk Analysis

Although models aim to ease complex decision making processes by representing reality, merely defining a model as a simplification of reality would be an underestimation of the intent of modelling. The complex environment surrounding and infusing the decision making process of foreign investment necessitates the use of models as ways of applying rational political risk analysis to complex issues.

During the development and design phase of this model building exercise, it was found that a model can only be as reliable as the components it is made of. The sources of data used when applying a model is an extremely important aspect to monitor, especially if the results of a political risk analysis based on a model

designed for this purpose is used for extrapolation in order to enable the anticipation of future risk. Ultimately, validation errors can also occur in model building, contributing to the various theoretical and methodological problems. Because these problems were discussed and illustrated in Chapter 3 it was at least to some extent, possible to circumvent these issues in the final product.

In examining existing credit and political risk ratings in order to gauge the current extent of rating methodologies (see Table 3.1), it was found that existing methodologies of country and political risk analysis are limited and include mostly macroeconomic indicators (as credit risk ratings do *per se*), measures of social structure and development, and political events that are primarily indicators of instability and/or regime change. What this book tries to present in Chapter 5 is a way of conducting not only macro type risk analyses, but also industry specific (type, size, structure, experience with foreign expansion), time specific (short, medium or longer term ventures) and investment climate specific political risk analyses.

This book faced a further problem, namely attempting to conceptually model the process through which political and economic environments actually affect projects. Determining the nature of potential constraints is a large part of the analytical problem as is the anticipation of the probability of their occurrence. Adding to an analyst's uncertainty is the nature of the relationship between the host country's political environment and the nature of the international firm investing in that country. In designing a model for political risk analysis, one has to remain aware of the weakness of a structural analysis of political risk in that it tends to become somewhat static. The model in Chapter 5 has been designed with a built-in robustness, as weights of factor indicators and timeframes (the past one, six or twelve months or even years) can be adapted to the specifications of the decision maker.

What Was Learnt From Other Models and Methodologies

As the operationalization of the research and final product of this book, the fifth chapter presents a model with weighted values given to each factor indicator of political risk. Calculations can be made to present a real probability chance that political risk might occur in a certain host country, or in a specific industry sector within a host country.

It is important to realize that the value of models and modelling approaches extend beyond the realm of only mathematical models as such. There exist, among measurement tools like scenarios for instance, other kinds of models that are of great value in management science. Scenarios are a well known and widely accepted method of identifying key political and economic risks and opportunities, as they allow for their constant comparative analysis.

The model offered in this book seems to lend itself toward a decision theoretic

model which allows for risk assessment, and aims to present an objective measurement tool that can be used to help decision makers find enough consensus over issues to eventually agree on a strategic action for foreign investment. Problem solving theory and decision theory are risk averse in the sense that they offer means or ways of designing strategies for managing political risk analysis and are assumed to be the more general theory underlying rational decision making under conditions of uncertainty.

Yet despite the best efforts at analyzing and managing political risks, there may still be no guarantee that any of the investment options analyzed by a political risk analyst and considered by the investor are certain. Political risk analysis also operates from the assumption that the world is not deterministic. To consider non-deterministic outcomes though, one has to model a tool for political risk analysis by resorting to ideas of probability. Still the role of analysis as used in political risk assessment, is to offer an exploration of the possible consequences of different courses of action that can be taken when making a decision to conduct foreign direct investment.

What The Asian Financial Crisis Can Show Political and Credit Risk Analysts Alike

As the discussion on the Asian Financial Crisis (AFC) developed, the application of political risk factors and their indicators were offered as an illustration of how they can be used in order to anticipate the occurrence of such events in future. The aftermath of the AFC is important to political risk analysts for a number of reasons, one of them being the major implications for the future development prospects of the affected countries which are often dependent on direct foreign investment and extremely large loans.

In an on-going debate, it is argued that credit rating agencies failed to forecast the AFC. Although some of the variables provided in the methodology used by rating agencies include factors relating to the political system, this book still contends that micro political risk indicators are either overlooked and underestimated or excluded from current risk rating models, and suggest that they be included in an improved model or early warning system for future use.

Granted, the competencies of credit risk agencies lie in the area of credit or sovereign default analysis and differ from the competencies necessary for political risk analysis. But credit ratings are often mistakenly used as comprehensive reflections of political and social conditions in countries.

The assumption that political events result in certain economic decisions is beyond dispute, but economic events also see certain political consequences. With hindsight, post-AFC analysis shows that government inability on the part of all governments involved was also a culprit in the contagion – an overlooked micro political risk factor.

The underlying political factors present before and during the AFC prompted this book to find factors, political and/or institutional, that contributed to

government inability to deal with the crisis and found that governments are becoming increasingly accountable to market confidence as well.

The test of political leadership during and after a crisis is surely a question of capable government, and is something that could have been monitored and measured as part of an "early warning" indicator by micro risk factors in a well-designed model for political risk analysis. The AFC, coupled with the role the IMF played and its continuous aftermath, cannot be exempt from an investigation founded in political risk analysis. Political governance should be of great concern in risk analysis practices as the bottom-line of any policy, government action or market sentiment.

By no means does this book suggest that a political risk analysis model can forecast a financial crisis, just as a credit risk rating methodology cannot measure political risk. But hopefully this model can serve as part of, or in conjunction with, an early warning system that might prompt financial analysts to subsequently look in other places as well for signs of possible danger.

Recognizing Political Risk

Political risk analysis per definition implies the ability to measure the amount and type of risk a country might pose. Analysts have to be able to look for and recognize signs that can act as clues to possible situations in which risk can occur for a potential investor. There is a myriad of criteria that can, although not necessarily, result in political risk. These "clues" or "signs" are risk factor indicators.

As this book attempted to show, systematically organized observations present data that can be scaled numerically. Statistical data, which is the easiest to come by, the easiest to work with, the cheapest and eventually also more reliable and widely acceptable, can be manipulated by means of aggregating and averaging figures to fit a framework of political risk concerns.

Apart from the problems associated with using aggregate data, it was found that the various levels of analysis represented by the model in Chapter 5 presented problems of their own. As an investigation into these issues became deeper, it was found that the problems of comparisons, of aggregate data analysis and that of cross-level analysis are interrelated. The book also reveals that causes of political risk are infrequently attributed to only one event or tendency in a country and that political instability does not necessarily always translate into political risk. More often than not, the level of political risk in a country is rather an outcome of combined "risky situations" amalgamated under certain circumstances.

Political risk encompasses not only politics, but also economics, socio-economics, social and societal factors, environmental factors, as well as the nature and the specific scope of the business involved. As these elements are constantly undergoing change, the assessment of risk necessitates detailed analyses of the various features of particular cases by means of a flexible model. What was found, however, was that the reality of time and costs often limit the depth and scope of

analysis. It would be wise for future political risk scholars and risk modellers to find indicators that are easy to handle and readily available without compromising the integrity, validity, quality and accuracy of a political risk assessment.

The book suggests that one criterion for “good risk factor indicators” of political risk is that the factor indicator, or the information from which it is calculated, should itself be and be made readily available. This is particularly important for developing countries where the resources to collect and process statistical information are limited and thus not regularly publicized or one hundred percent valid (not that all countries do not “round-off” their figures). The rationale behind this is that factor indicators for which information is difficult and/or expensive to collect, are much less likely to be put into practice than factor indicators for which the information can be easily and cheaply collected.

Also, risk factor indicators and their direction (“up” or “down” as related to being “good” or “bad”) should be relatively easy to understand and should reflect something measurable, something believed to be important or significant in its own right, or reflect or represent something important beyond what the factor indicator itself is a measurement of (for instance, life expectancy figures might be used to indicate the general state of health of the economically active population). One way to build up a set of factor indicators from an inexhaustible pool of risk factors is to decide which are the most important problems to keep track of, again emphasizing the importance of gauging a client’s specific needs to enable micro-type analysis.

The “economics of political risk” is not a contradiction in terms. If government makes decisions or rules as to the economic systemization of a country, policy is made. And where policy is made, politics is involved. In assessing political risk, MNCs must give ample weight to elements of political control as well as to various cultural constraints on the control and influence they can wield in a host country, here “host” implies precisely that the foreign investor is indeed a guest in any country other than the home country. Using economics as a contributor to political risk is certainly one of the more important factors in risk analysis. A country’s macroeconomic policy provides a framework of the economy’s prospects, performance, and flexibility, and is closely bound to the political structure which foreign investors are interested in when considering the most profitable investment climate.

It Is Possible to Measure Political Risk...

The fifth chapter explained how the model for political risk was designed and “put together”. Due to the weighted values of the total political, economic and social risks being weighted in calculating risk probability, the real percentage probability calculation was used in the book as the most reflective value of the calculated probability that political risk might occur. Total political, economic and social risk(s) are weighed as 50%, 30% and 20% respectively. But due to the proven flexibility of the model, an investor can choose to weigh these differently at 60%, 20% and 20% respectively, or 40%, 35% and 25%. A decision maker’s

participation in deciding on which political risk factors should be included or omitted when designing a model best suited to a project's or organization's needs, increases client ownership of a political risk analysis that will assist during the decision making process.

...and to Manage Political Risk

Foreign investors put assets at risk to achieve their objectives and the assessment of these risks, including political risks, is the key to successful operations. Opportunities and risks are often two sides of the same coin and political risk comprises a large part of the environmental forces in terms of the management challenges an MNC faces in any investment climate.

A firm's foreign investment strategy deals with the positioning of the organization in an uncertain host country environment and investment climate. In the sixth chapter, the book attempted to explain how a firm's political risk exposure, which refers to the sensitivity of a firm's projected profitability and operationability in a host country to changes in the investment climate, could be managed and reduced. It is hoped that political risk analysis and management can assist foreign operations in managing the risks that might have otherwise proven to be destructive to profitability and operationability. One can thus view political risk management to constitute the sum of the actions a foreign investor or an MNC takes to try and keep at an acceptable level the degree or measure of investment risk associated with their activity in a host country.

By the very nature of their definition, MNCs face an additional and unique element of risk, being the political risk of operating in countries with different political philosophies, legal systems, and social attitudes toward private property, corporate responsibility and free enterprise. Furthermore, MNCs attract a lot of attention, especially in developing countries, as wielders of economic power when bargaining with governments of host countries.

In thinking about managing political risk, it was found that the relationship between MNCs and the host governments can be either mutually beneficial or mutually detrimental. This relationship can also manifest itself in cases where especially governments of developing countries become increasingly vulnerable to the power that large MNCs wield, just as MNCs can bear the brunt of host government power.

The book suggests that possible means of managing political risks and the threat that such potential risks might pose include integrative and protective management techniques that an MNC might use to manage the impact of political risk; political risk insurance; formulating a political risk policy; as well as political risk impact-probability management. It also touches upon certain strategies that both governments and MNCs can follow in an attempt to reduce and manage not only the impact that political risk might have on a country's investment climate, but also the roles that they both play as possible risk agents in managing their relationship.

Scope For Further Research

There still remain some very important questions that should guide further research into the conceptualization, measurement and analysis of political risk and management, and relate to the notion and conceptualization of political risk itself being made more precise.

A challenge that was not covered in any great detail in this book, but by no means distracts from its importance, is the perception that political risks or investment risks, are narrowly regarded as being the nemesis of only emerging economies. There lies a great danger in underestimating the importance and necessity of conducting thorough political risk analyses, even in highly industrialized countries.

Where default risk is reflected in the macro-economic indicator of the balance of payments sheet, a factor often used as an indication of political risk as well, even developed countries can reflect at least some level of risk in this regard. Since political decisions (like foreign policy and trade policy formulation) and events substantially influence balance of payments trends, political risk analysis should rightly be incorporated into risk assessments of industrialized countries.

Political risk analysis and risk management is not only concerned with the political and economic events in a country, but also with the sub-national socio-economic dynamic within countries and the impact world events have on them. Industrialized and newly industrialized countries alike are not exempt from thorough political risk analyses, as the practice of such assessments is not only limited to the study of political risks in developing countries. A "low risk" environment can actually pose certain types of risks themselves, like high safety regulations; tough labour and environmental regulations; saturated markets; a limited pool of skilled, available, and inexpensive labour; and expensive capital and technological intensive operations. The uses of political risk analyses border on the inexhaustible.

There is also further scope for research in testing the more complex contingency relations between the many uncertain dimensions of host country environments and MNCs' strategic responses. Uncertainty seems to be treated as a single construct, which it is not. Often one type of uncertainty is isolated in an MNC's strategic response to the exclusion of others. A more comprehensive response is needed by MNCs, and the ways of formulating such comprehensive strategies can be aided by further research into the designing of political risk policies (Miller, 1992).

As mentioned before, the scope for further study in the field of measuring political risk allows for a more in-depth investigation into the abovementioned precision of a set of indicators used for analyzing risk. The arbitrary nature of political risk analysis can be remedied by incorporating standardized and transparent values already attributed to political indicators. There was a surge in good databases during the past decade or so that measure political attributes and

thus enable comparative studies. Although this book is aware of these standardized measurements, it admits to the aim of addressing the challenge of attempting to build a unique and comprehensive model for political risk analysis independent from these measurements. This is quite possibly a limitation to this book, and an even more advanced study should without a doubt further address remedying the more arbitrary and nominal nature of that which can be deemed political risk.

There is also scope for research regarding the effect of political risk factors on financial markets, where the movements and reactions of these markets might prove to be a result of ensuing political risk. Strike season, wage stand-offs, and lost man-hours and man-days due to labour disputes directly influence the pricing of shares and stock. The stock and equity price information that traders have at their disposal regarding international markets are constantly complemented with information regarding the latest announcements and current events. For instance, it is quite interesting to witness the movement of markets after certain national unemployment figures have been announce or after the announcement that trade negotiations have produced certain (un)expected results. Announcing interest rate cuts or hikes also sees movement in the markets as does the advent of strike action. The effect of technological advances in specific industries will impact directly on industry participants, where these technological advances are often the result of trade agreements between countries as the sharing of technological know-how becomes a spin-off of various trade agreements.

The scope for further research into political risk analysis and management is close to inexhaustible. Every political risk factor identified in this book can justify a study in its own right.

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